State of Washington
Legislative Budget Committee

STATE INVESTMENT BOARD

Report 92-7

November 20, 1992

TABLE OF CONTENTS

Chapter Page

Appendices

MAJOR FINDINGS:
State Investment Board

- The need for the SIB to better protect the interests of the pension funds' stake-holders, and generally to improve its decision-making process.

- The need for valid and meaningful measurement and reporting of SIB investment performance.

- The need to follow the State's competitive bidding requirements in issuing personal services contracts.

- The need to create an environment less conducive to potential conflicts of interest.

- The need for both internal and external oversight of the SIB.

RECOMMENDATIONS

Summary

Recommendation 1

The procedures being developed by the SIB's alternative investment consultant for screening and evaluating future investments should take into account the several problem areas identified in this report. These problems include:

- o Lack of general partner financial participation
- o Fees unrelated to performance
- o Situations where the SIB has a disproportionate amount of the risk
- o Situations where the general partner's carried interest can be on gross rather than net gains
- o Vague and open-ended contractual language
- o Lack of caps or other specific limitations on expenses

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	Not specified (See Recommendation 12)

Recommendation 2

In addition to validating management fees, the board's senior investment officer should establish procedures to validate expenses and to ensure that allocations and distributions are made and have been made in accordance with partnership agreements.

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	Not specified (See Recommendation 12)

Recommendation 3

The SIB should avoid making investments or entering agreements that involve actual or potential conflicts of interest on the part of managers, contractors, and partners. Toward this end, the SIB should establish procedures for: identifying potential and actual conflicts of interests in proposed investments and agreements; ensuring that all board members are formally notified of such conflicts; and requiring that such notification is reflected in board minutes.

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	None specified (See Recommendation 12)

Recommendation 4

The legislature should amend Chapter 39.29 RCW to require that subcontracts within personal services contracts follow competitive procurement requirements. Exemptions to the competitive process for subcontracts should be the same as for personal services contracts and should be filed with and approved by the Office of Financial Management. An exception to this requirement would apply in the event that the use of subcontractors is specifically addressed within the scope and budget of an existing contract, and that such use was taken into account when the contractor was originally hired through a competitive process.

[Note: The language below was added to Recommendation 4 by LBC amendment.]

Further, the legislature should amend Chapter 39.29 RCW to include a new section with the following language:

Criteria for Amending Personal Services Contracts. (1) Amendments to personal services contracts, wherein the value of the amendment(s), whether singly or cumulatively, exceeds fifty percent (50%) of the value of the original contract, and/or where the amendment substantially changes either the scope of work specified in the contract or the scope of work specified in the formal solicitation document, shall be provided to the office of financial management and the legislative budget committee.

(2) The office of financial management shall approve amendments provided to it under this section before any amendment becomes binding and before any services may be performed under the amendment.

(3) The office of financial management shall not approve amendments provided to it under this section unless they meet the criteria for exemption from the competitive solicitation process as established by the director of the office of financial management.

(4) All substantial changes in either the scope of work specified in the contract or in the scope of work specified in the formal solicitation document shall be submitted to the office of financial management and the legislative budget committee as contract amendments.

Legislation Required: Yes
Fiscal Impact: None
Completion Date: None specified

Recommendation 5

The SIB, in developing investment policies and procedures for real estate investments, should address the problems mentioned in this report. Specifically:

- Portfolio diversification requirements.
- A process and standards for evaluating proposed investments.
- A process and standards for monitoring investments, including verifying that management fees, expenses and allocations of income are in accordance with the contracts.
- Standards for legal and business review of proposed investments including ensuring that contractual conflicts of interest are minimized, and those that are unavoidable are disclosed to board members, and that the contracts are not extraordinarily complex.
- A process and standards for evaluating real estate managers.

Legislation Required: No
Fiscal Impact: None
Completion Date: None specified (See Recommendation 12)

Recommendation 6

When hiring consultants to provide advice on managing specific investments, the SIB should direct the consultants to consider and analyze a full range of alternative courses of action.

Legislation Required: No
Fiscal Impact: None
Completion Date: None specified (See Recommendation 12)

Recommendation 7

When consultants are retained to analyze investments, the SIB should require candidates for the work to disclose potential conflicts of interest. If a firm which has potential conflicts of interest is considered for selection by the SIB, the SIB board members should be made aware of the potential conflicts of interest, and consider them in their selection process.

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	None specified (See Recommendation 12)

Recommendation 8

The SIB should initiate a policy in which consultants who recommend a course of action that includes a requirement for follow-up consultant work should not generally be eligible to compete for the follow-up work. There may be situations which require exceptions be made to this policy. If so, documentation of why the exception is required should be made. Consultants should be made aware of this policy prior to their retention for consulting services.

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	None specified (See Recommendation 12)

Recommendation 9

[Note: By amendment, the LBC consolidated Recommendations 3 and 9 from the preliminary report into a new Recommendation 3 in this approved final report. See Recommendation 3.]

Recommendation 10

The LBC should request the Joint Board of Ethics to advise the legislature as to any parameters that should be set concerning the acceptance of campaign contributions by legislators who serve on the SIB.

Legislation Required:	No (but this is an LBC action item).
Fiscal Impact:	None
Completion Date:	None specified

Recommendation 11

The State Investment Board should address the issue of the circumstances under which members should exclude themselves from voting. One of the circumstances specifically considered should be the acceptance of campaign contributions.

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	None specified (See Recommendation 12)

Recommendation 12

The State Investment Board should prepare a report to the LBC by March 1, 1993, that will indicate the actions taken by the board in response to the formal findings and recommendations of this report, and in response to the other matters referenced herein.

Legislation Required:	No
Fiscal Impact:	None
Completion Date:	March 1, 1993

[Note: By amendment, the LBC edited this recommendation for clarity.]

Recommendation 13

The Legislative Budget Committee should perform a follow-up performance audit of the SIB during the 1993-1994 fiscal year.

Legislation Required:	No (but this is an LBC action item).
Fiscal Impact:	None
Completion Date:	None specified

BACKGROUND

Chapter One

Overview

The legislature created the State Investment Board in 1981 in order to centralize the investment of public employee pension funds and state trust funds. Prior to that time, the various retirement agencies were responsible for the investment of public employee pension funds and the State Treasurer was responsible for the investment of the public trust funds. Currently, the SIB has approximately $22 billion under investment. This amount includes approximately $16.5 billion of employee pension funds, $5 billion of Department of Labor and Industries (L&I) trust funds,[1] and $.5 billion of other state trust funds.[2]

Composition of SIB

The SIB consists of nine voting members and five non-voting members. The nine voting members include three ex-officio members, one legislator from each house, and three governor appointees who represent various constituencies of stakeholders in the public employee pension systems, and one appointee by the Superintendent of Public Instruction (see Appendix 3). The five non-voting members are appointed by the voting members of the SIB and are directed by statute to be "considered experienced and qualified in the field of investments" (RCW 43.33A.020). Trustee-

[1]Department of Labor and Industries funds include the Accident Fund, the Medical Aid Fund, the Accident Reserve Fund, and the Supplemental Pension Fund.

[2]Other state trust funds include the Game Special Wildlife Fund, the Self-Insurance Revolving Fund, the Agricultural College Fund, the Millersylvania Park Permanent Fund, the Normal School Permanent Fund, the Permanent Common School Fund, the Scientific School Permanent Fund, the University Permanent Fund, the State Employees Insurance Reserve Fund, and the Radiation Perpetual Fund.

ship of the funds under the authority of the SIB is vested in the voting members. The purpose of the nonvoting members is to "advise the voting members on matters of investment policy and practices" (RCW 43.33A.030).

Legislative guidelines to SIB

The legislature gave the SIB broad investment authority with few restrictions on investment decisions. The only statutory restriction is that "any investments shall be made with the exercise of that degree of judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation but for investment, considering the probable safety of their capital as well as the probable income to be derived" (RCW 43.33A.140). This language is known in common law as the "prudent person rule."

The legislature also gave general direction to the SIB on its goals for investment. "The board shall establish investment policies and procedures designed exclusively to maximize returns at a prudent level of risk" (RCW 43.33A.110). The only exception to this direction is in the case of the Department of Labor and Industries funds, for which the board shall, "establish investment policies and procedures designed to attempt to limit fluctuations in industrial insurance premiums and subject to this purpose, to maximize returns at a prudent level of risk" (RCW 43.33A.110).

INVESTMENT DECISIONS AND FIDUCIARY RESPONSIBILITY

As pointed out above, the legislature gave broad authority to the SIB to make investment decisions, subject to the prudent person rule. The prudent person rule is a standard of common law which is used to judge the conduct of fiduciaries. A fiduciary is broadly defined as, "a person who has legal responsibility for the conservation and management of property in which another person has a beneficial interest."[3]

[3]Martin, Lawrence A., *The Legal Obligations of Public Pension Plan Governing Boards and Administrators*, 1990, a monograph of the Government Finance Officers Association, p.34.

Voting members of the SIB are statutory trustees of the funds the

SIB invests and owe fiduciary duties with respect to them. While persons other than voting members of the SIB may owe a fiduciary duty if they have discretion over investment decisions, their status as fiduciaries is far from certain, according to the Assistant Attorney General (AAG) representing the LBC.

Having fiduciary responsibilities requires the fiduciary to exercise a rigorous standard of care in making decisions, and the judgment of the standard of care is the prudent person rule. However, there are other duties of pension fund fiduciaries.[4] Among these additional duties are:

Duties of fiduciaries

- The reuirement that all pension plan activities be carried out in the sole interest of pension plan participants and beneficiaries;
- The requirement that the investments of the pension plan be diversified to minimize the risk of large losses unless it is clearly determined to be imprudent to diversify;
- The prohibition on fiduciaries causing the pension plan to engage in various specified prohibited transactions, which include dealings with interested parties and self dealing;
- The prohibition on direct or indirect profit by the pension plan management personnel from the pension plan investment activity, the prohibition on pension plan management personnel dealing on a basis other than with third parties in an arms length transaction, and the prohibition on plan management personnel self dealing; and
- The requirement that persons connected with the pension plan publicly disclose any potential or actual interests resulting from personal investment holdings.

[4] *Ibid.*, pp. 39-40

OVERVIEW OF SIB INVESTMENTS

The investment goals of the SIB vary between the pension funds and the L&I funds. As stated above, the goal given to the SIB by the legislature for investment of pension funds is to maximize returns at a prudent level of risk. The goal for the L&I is first to minimize fluctuations of industrial insurance premiums and second to maximize returns at a prudent level of risk. Because of the different investment goals for the two major components of the SIB's investment responsibility, the SIB has chosen different investment allocations for the two components.

Investment goals

The $5 billion of L&I funds are primarily invested in corporate and government fixed income securities. This is done because fixed income securities are less volatile than many other types of investments, and this investment choice is considered to be consistent with the primary goal to minimize fluctuations of industrial insurance premiums. About 4 percent of L&I funds are invested in a stock market index fund. The remaining 96 percent is invested in fixed income securities or cash instruments.

Because of the different investment goal of the pension funds, the asset allocation of these funds is considerably different than the L&I funds. Of the pension funds, about 38 percent is invested in fixed income or cash, 38 percent in corporate stocks, 10 percent in leveraged buyout funds,[5] 6 percent in asset allocation investments,[6] 6 percent in real estate, and 2 percent in venture capital funds (see Exhibit 1).[7]

[5]Leveraged buyout funds are investments in partnerships whose goal is to earn high returns by using relatively small amounts of cash and relatively large amounts of debt to acquire companies.

[6]An asset allocation investment is one in which a money manager can invest the funds in either stocks or bonds according to the manager's discretion. Therefore, depending on the choices of the manager, this investment adds to the total amount of investments in both stocks and bonds.

[7]Venture capital funds are partnerships which invest in new companies or new technologies which show a potential for growth and a high return on investment. It is noted that the SIB has recently initiated a strategic planning process to determine the appropriate allocation of its assets to

various types of investments. Through this process, the SIB will receive expert advice from its general pension consultant about how to structure its portfolio. Studies have shown that a formal asset allocation (strategic planning) process is a crucial determinant of portfolio performance.[8] We believe the use of expert consulting services to provide advice on asset allocation is a substantial improvement over past practices when there was no formal strategic planning.

Exhibit 1

[8]For example, see Brinson, Hood and Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal*, July/August 1986, or Hensel, Ezra and Ilkiw, "The Value of Asset Allocation Decisions," *Russell Research Commentaries*, March, 1990, or Brinson, Singer and Beebower, "Determinants of Portfolio Performance II: An Update," *Financial Analysts Journal*, May/June, 1991.

SCOPE OF THIS REPORT

Many issues concerning the practices of the SIB had been identified prior to the commission of this performance audit. Many of these issues had been identified as a result of studies initiated by the board into its own operations. These studies included a review of venture capital agreements conducted by the law firm of Foster Pepper & Shefelman, and an organization and operations study conducted by the consulting firm, Deloitte & Touche. Other issues concerning SIB operations were raised by press reports, particularly by the *PI*.

The scope and objectives of the LBC audit of the SIB were to address two general issues (see Appendix 1). Generally stated, they are:

Scope and objectives

- Is the SIB creating policies and procedures that will adequately address previously disclosed and alleged problems?
- What kind of ongoing legislative oversight should there be of the SIB's operations and investment performance?

In order to answer these questions, we have reviewed the operations of the SIB and have attempted to verify and understand the problems that were identified. In many cases, we verified that the previously disclosed problems currently exist or have existed in the past. Frequently, we also found that the underlying problems were more serious and complex than had been previously reported.

Areas not Included in this Report

Because of the complexity of the SIB's investments and the problems associated with those investments, and the time constraints of producing a report that would be responsive to the legislature's needs, we do not consider this to be a complete performance audit of the SIB.

For example, we did not review the SIB's fixed income investment process. Fixed income investments represent over $10 billion of the $22 billion under investment by the SIB. However, there were relatively few problems that were identified by Deloitte & Touche with the fixed income investment process. These investments are managed in-house, and therefore are not subject to many of the

concerns that are associated with the SIB's other types of investments.

Also, we have not conducted a detailed review of the SIB's process for making investments in the stock market through stock market portfolio managers. In response to the finding by Deloitte and Touche that the SIB had no formal process for selecting, evaluating, and terminating stock market managers, the SIB is now implementing a competitive process for selecting stock market portfolio managers. The SIB's new pension consultant will also assist in the development of criteria for selecting, evaluating, and terminating portfolio managers.

Areas that are Covered by this Report

What is covered in this report in detail are those areas where we felt the previously identified issues were the most serious. These areas include: the SIB's reported investment performance and comparisons of performance to other pension funds; the process for selecting and monitoring managers of venture capital investments; the process for procuring personal services contracts; the process for selecting and monitoring real estate investments; the use of a code of ethics and issues of conflicts of interest; and the need for ongoing oversight of the SIB's operations by the legislature. These matters are the subject of later chapters of this report.

Previously identified issues

We also note that those specific investments that are a subject of this report constitute a minority of the total investments of the SIB. The investments we reviewed in detail (venture capital, leveraged buyouts, and real estate), are significant, however, in that they represent approximately $3 billion of SIB investments. These are about 14 percent of the $22 billion under investment with the SIB, and about 18 percent of the pension fund investments.

CHANGES IN SIB OPERATIONS

Many of the issues that are discussed throughout this report have resulted from past investment decisions and investment practices. We acknowledge that individual board members have had concerns with the operations and with some of the investments of the SIB in the past. The majority of the board felt strongly enough about these concerns toward the end of 1990 that they initiated analyses of

individual investments and began the process that resulted in the subsequent reports by Deloitte & Touche and the law firm of Foster Pepper and Shefelman.

SIB addressing many issues

We also acknowledge that the SIB is currently making broad changes to its investment policies and practices in order to address many of these problems. In many cases, we believe that positive steps are being taken to improve the operations of the SIB. But in other cases, we believe further improvements are warranted.

Information denied to LBC

Also, in one case, we are unable to assess the process that is underway to evaluate a major issue that is currently before the SIB. This process concerns the SIB's alternatives for dealing with the Prentiss/Copley real estate investment that is losing value. We are unable to evaluate the SIB's decision-making process on this investment because crucial information has been withheld by the SIB. This information is a report prepared by the SIB's business and legal consultants on business and legal options available to the SIB. The report was withheld by the SIB on the grounds that release of the report would constitute a waiver of the SIB's attorney-client privilege, and the report might then have to be released to anyone who requested it. The SIB's position is that the report could damage its case in a potential litigation.

The fact that changes are being made to operating practices and polices complicates the audit process because in many cases the SIB has recognized that a problem exists, is taking steps to address the problem, but has not yet fully implemented their solution to the problem. Therefore, in some cases, while the SIB is taking steps to address problems in its operations, we have been unable to provide a complete evaluation of the adequacy of those steps since they have not yet been fully developed and implemented. In other cases we have been able to evaluate the changes that are taking place, and in some instances are recommending additional corrective actions.

OVERALL INVESTMENT PERFORMANCE

Chapter Two

In their organization and operations review of the SIB, Deloitte and Touche raised the issue that the SIB calculates and reports on its own performance without outside auditing of the calculations. Deloitte and Touche questioned whether it is a standard industry practice for a pension fund to calculate and report its own performance. The *PI*, in raising the same issues, also questioned whether the SIB knows the value of its investments without an outside audit. Members of the legislature have also raised questions about the SIB's performance calculations.

Previously disclosed issues

LBC STUDY OBJECTIVES

Our objectives in reviewing the overall investment performance of the SIB were to verify the accuracy of the SIB's performance calculations and to assess the validity of the SIB's comparisons of performance with other funds.

REPORTED HISTORICAL INVESTMENT RETURNS

The SIB's quarterly and annual reports include separate measurements of the investment performance of the two major categories of funds, L&I and retirement funds. When information is presented comparing the SIB's investment return to other pension systems, the performance of the L&I funds is not included in the comparison. Performance of the L&I funds is reported separately because the L&I funds are not pension funds, and are invested differently from the pension funds.

Performance comparisons

Performance information presented in the SIB's annual reports has consistently indicated that the SIB is among the best, if not the best, performing public pension fund among those in the comparison group. For example, both the 1990 and 1991 annual reports of the SIB included charts that indicated that the SIB was the best performing pension fund over the previous ten-year periods.

When problems with SIB investment practices first started coming to light in 1991, defenders of past practices of the SIB consistently pointed to the SIB's superior investment returns. The notion that the SIB is the best performing pension fund in the country is widespread. For example, as recently as April 5, 1992, a Seattle *Times* article referred to the SIB as "the best performing fund of its kind in the U.S."[1]

FINDINGS

Value of SIB Investments

Accuracy of valuations

The question of whether the SIB knows how much money is under investment was raised by the *PI.* Although we did not conduct a financial audit to verify the value of the SIB's holdings, we note that the reported value of SIB holdings is subject to an annual financial and compliance audit by the State Auditor. The State Auditor raised no issues with the SIB's reported fund valuations in the recent 1991 Audit Report.

However, some caution should be used in accepting the reported valuations of SIB investments. Certain investments held by the SIB (e.g., venture capital, real estate, and leveraged buyout funds) are illiquid and cannot be traded on open markets. In these cases, valuations of holdings are estimated by investment managers. Because these are estimates of value, it cannot be certain that the managers' valuations are completely accurate. This circumstance is unavoidable in investments that are not traded in open markets.

[1]Seattle *Times,* April 5, 1992, p. C1.

SIB Performance Calculations

We reviewed the investment returns reported by the SIB since its inception in 1982 and found that investment returns have been overstated. There are two reasons for this. Investment returns calculated by the SIB are gross returns prior to deduction of manager fees, while the performance of the comparison group is calculated using net returns. Also, we found errors in the data used for calculating performance by the SIB.

SIB performance was overstated

The SIB has calculated its own performance in the past. The calculation relied upon data entered by SIB staff into a computer program on the SIB's mainframe computer. The performance calculation required the input of thousands of pieces of information on investment earnings and external cash flows into and out of the system (contributions from, and benefit payments to, the pension systems). While we found no errors in the methodology for calculating returns, we did find examples of mistakes in the data input.[2]

Errors in performance data inputs

Given the huge task of verifying the accuracy of the individual data inputs into the computer, and recognizing that there have been mistakes in data entry, we calculated performance using a much simpler approach. Although this approach is slightly less precise than the SIB's method, we feel that it is likely to be more accurate since it does not rely on the accuracy of thousands of data inputs. Our methodology utilizes much fewer numbers, all of which have been audited for accuracy by the State Auditor.

The reason this approach is slightly less precise is that it is not as sensitive to the specific time during the course of the year when investment income was received, or cash was received from the pension system, or other source. For example, our methodology assumes that all of the net growth in the pension funds due to contributions from the pension system occur at mid-year, when actually these payments are received throughout the year. We

[2]For example, in our review of the performance of venture capital investments, we found discrepancies between the financial statements of the investments and the information input into the SIB's computer. Venture capital investments involve relatively few transactions. The errors found in data input for investments that involve relatively few transactions raise questions about the overall accuracy of the SIB's self-performance calculations.

believe that the lack of sensitivity to the timing of cash flows would

reduce the accuracy of the calculation only slightly because the errors would tend to cancel out. For example, if a cash payment was received from the pension systems at the beginning of the year causing a slight error in our method of performance calculation, this error would be offset by cash payments received at the end of the year.

We used the following information to calculate performance: the beginning and ending fund balance of the pension funds for each year as reported by the SIB (and audited by the State Auditor); and the contributions to and benefit payments from the pension funds for each year as reported in the state's annual Comprehensive Annual Financial Report (CAFR).

Gross versus net performance

Using this approach, any change in the pension fund balance, other than the net increases in the fund due to contributions from, and benefit payments to, the pension system, is due to return on investment. Note that this methodology calculates returns on investment net of fees and expenses, since the payment of fees and expenses would be reflected in the year-ending fund balances. This is different from the SIB's calculations which have measured gross performance.

Significance of performance calculations

Based on this approach, we found that the 10-year annualized return of the pension funds, as of June 30, 1991, is 14 percent. This compares with the SIB's published annualized return of 14.9 percent for the same 10-year period. Part of the difference between the two is attributable to the fact that we calculated a net return while the SIB calculates a gross return. The difference between a 14.9 percent annual return and a 14 percent annual return may seem minor. However, the difference would represent approximately $1 billion in earnings.

The fact that we calculated a lower return on investment than the SIB does not mean there is less money in the pension systems than has been reported by the SIB. The significance of this difference is that had the SIB earned a 14.9 percent annual net return for the past ten years, there would have to be an additional $1 billion in SIB holdings over the current $22 billion.

SIB Performance Comparisons

We found that the SIB's comparisons of performance with other funds were misleading. The comparison group that the SIB has used is the SEI State Retirement Plans. This is a group of 23 public funds within 13 states that subscribe to SEI Funds Evaluation Services. In addition to the fact that this is a very small comparison group, we found that the group is not comparable to the SIB. For example, many of the funds within this group are restricted in their investment choices by their state legislatures. In fact, one of the funds within the group can only invest in fixed income investments. In our opinion, this is not a relevant comparison group because there are no specific legislative restrictions on the SIB's investment choices, (except for the L&I funds, which are not a part of the performance comparisons).

Misleading performance comparisons

SEI Funds Evaluation Services also maintains a database of over 5,000 public and private pension funds (SEI Balanced Funds). We feel that if comparisons of performance to other pension funds are to be made, SEI Balanced Funds is a more appropriate group for comparison for two reasons: (1) it is broader and therefore less likely to be skewed; and (2) because it includes mostly private pension systems, it may be less likely that there are significant external restrictions on investment choices. Also, it is impossible for any of the funds in this group to have broader investment discretion than the SIB. Therefore, we feel that it is appropriate to compare the SIB's performance to private pension systems because it allows for a much broader comparison group that is less likely to be skewed.

Need for a broader comparison group

When we compared the SIB 10-year annualized net investment return to the median return of the SEI Balanced Funds we found that the SIB's performance was slightly less than the median pension fund (see Exhibit 2). Note that the SEI Balanced Funds report net investment returns, as does our calculation of the SIB's investment returns.[3] Also, using the SIB's own calculations of

[3] Since the publication of the preliminary report, the SIB has informed the auditors that the SEI Balanced Funds reports gross rather than net returns. This contradicts what SEI Funds Evaluation Services had told the SIB in April 1992, when the SIB was told that the SEI Balanced Funds reports net returns. We have also confirmed with the SIB that SEI Funds Evaluation Services does not verify the performance information provided by pension funds to determine whether fees are included in the information.

performance, the SIB's gross performance was better than the net performance of the median fund of the SEI Balanced Funds, but less

Exhibit 2

than the performance of the upper quartile.[4]

We believe this finding is important because if SIB board members had been given more accurate information in the past about the SIB's performance, it may not have taken as long for the board to recognize some of the problems that are detailed later in this report. Because board members were consistently informed that the SIB was one of the best performing funds in the country, it was likely that there was less urgency on the part of board members and others to question investment practices.

We note that the SIB has recently discontinued its practice of comparing its returns to those of the SEI State Funds. In the future, SIB performance returns will be calculated by the Bank of New York, which is custodian of SIB funds, and Wilshire Associates, the SIB's new general pension consultant, has committed to provide a more valid and meaningful comparison of the SIB's performance than had been provided by the SIB formerly.

Changes to SIB performance measurement

IMPACT OF PAST PERFORMANCE ON FUTURE PERFORMANCE

Past performance calculations presumed a profit from certain investments that was never realized. For example, past performance measurement assumed a substantial return from the Prentiss/Copley real estate investment. But these profits were on paper only. The SIB's $405 million investment in the Prentiss/Copley real estate portfolio is currently valued at $256 million. Between 1987 and 1990, the SIB's performance included assumptions of profits from this investment. However, since these profits were on paper only, and losses were not recognized until recently, current performance is impaired by the losses of this 1987 investment.[5] The fact that past performance was overstated because of

Losses on past investments impact current performance

[4]The median fund of the SEI Balanced Funds returned an average net return of 14.2 percent per year for the ten year period ending June 30, 1991. The net return at the 25th percentile was 15.2 percent for the same period. This compares to the SIB's calculated gross return of 14.9 percent for that period. The audit team calculated a 14.0 percent annual net return to the SIB for that period.

[5]Chapter 5 of this report discusses the Prentiss/Copley real estate investment in more detail.

the presumed profits from an investment that is currently losing value does not mean the SIB erred in its calculation of performance

from this investment. Rather, it illustrates the difficulties in measuring the performance of illiquid investments.

The foregoing is important because future performance of the SIB may be lowered because of possible further losses of investments made in the past. We have been told by defenders of past practices of the SIB that current efforts to change the operations and investment practices of the board will result in lowered performance, because cumbersome policies and procedures will preclude the board from seizing upon emergent investment opportunities. In response, we have not observed that the policies and procedures that have been developed to date are overly cumbersome.

Impact of operational changes on performance

Furthermore, we note that the general class of investments that might be described as "emergent investment opportunities" has historically underperformed in relation to other investments of the SIB.[6]

Part of the reason why some investments made in the past are currently performing poorly may be because of deficiencies of past investment practices. If so, then current and future performance may be lowered because of the deficiencies of past investment practices.

ACTIONS BEING TAKEN BY THE SIB

The SIB will no longer calculate its own performance but instead will have performance calculated by the Bank of New York, which has custody of SIB investments.

The SIB's new general pension consultant, Wilshire Associates, has committed to provide a more meaningful comparison of the SIB's performance.

The SIB has also commissioned Wilshire Associates to validate the SIB's performance calculations for the past five years. This project will not be completed until 1993.

[6]We are referring to venture capital, real estate and leveraged buyout investments. ~~While leveraged buyout investm~~ents have performed well, that performance has been offset by losses incurred in the SIB's real estate investments and the poor performance of the SIB's venture capital investments.

VENTURE CAPITAL AND LEVERAGED BUYOUTS (ALTERNATIVE INVESTMENTS)

Chapter Three

The SIB's alternative investments include twenty-three limited partnerships and several leveraged buyout (LBO) funds.

Background

Venture capital funds are limited partnerships that typically invest in development-stage companies; for example companies seeking to develop new products or new technologies. Venture capital is a high risk investment that has the potential for bringing high returns. Of the SIB's 23 limited partnerships, 21 are venture capital funds and two are structured similar to the venture capital funds but their strategy is not limited to investments in development-stage companies. Since its creation in 1981, the SIB has committed capital in the amount of $493 million to the 23 partnerships. The estimated value of assets remaining in venture capital funds (which does not include previously distributed gains) is $312 million. This is roughly 2 percent of the $16.5 billion in pension funds. The annual rate return on the SIB's venture capital investments over the last five years has been about 1 percent.[1]

Leveraged buyouts are a type of investment that uses relatively small amounts of capital and large amounts of borrowing (leveraging) to acquire companies. Like venture capital, LBOs are considered to be risky investments that have the potential for high returns. Since 1982 the SIB has committed nearly $1.2 billion to five LBO funds, all with Kohlberg Kravis and Roberts (KKR). Each fund is divided into several limited partnerships, each created for

[1]This is the time-weighted rate of return as reported in the SIB's quarterly report dated March 31, 1992.

the purpose of acquiring an individual company. The estimated

value of assets remaining in LBO funds (which does not include previously distributed gains) is $1.6 billion. This is roughly 9.7 percent of the SIB's pension funds. The annual rate of return on LBOs over the last five years has been about 20.1 percent.[2]

PREVIOUSLY DISCLOSED ISSUES

Problems in venture capital partnerships

At the end of 1990, the SIB became aware of some troubled investments with a venture capital partnership called KBA. The SIB was invested in two limited partnerships with KBA at the time, and had committed capital totaling $78 million.[3] The board was particularly concerned about the difficulty of withdrawing from these partnerships if conditions were to deteriorate. Early in 1991, the SIB contracted with a law firm and two other consultants to provide specialized expertise and advice regarding KBA. Another law firm, Foster Pepper & Shefelman (FPS), was hired to review the remaining twenty-one venture capital and other limited partnership agreements.

FPS presented its report in May 1991. The report mentioned that the industry-wide recent performance for venture capital investments had been poor, but also pointed out that some of the SIB's partnerships were significantly lagging behind industry standards. From its review of partnership agreements, FPS noted the lack of limited partners' rights and the broad powers granted to the general partners, but concluded that this was not particularly unusual for venture capital partnerships. However, FPS pointed out that in the current investment climate, where there is more competition among general partners to find financial backing, that the SIB could be more aggressive in seeking concessions. FPS also recommended that the SIB henceforth ensure that modifications and amendments to agreements receive a legal review.

[2] *Ibid.*

[3] The SIB committed $33 million to KBA Partners and $45 million to KBA Partners II. Since 1987 the SIB has contributed a total of $33 million and $41.8 million, respectively, to these partnerships. KBA Partners has returned $16.3 million to the SIB and KBA Partners II has of yet made no distributions. According to the SIB's March 31, 1992 quarterly report, the value of the two partnerships' remaining assets totals $17.1 million ($8.2 million and $9 million respectively).

In conjunction with its review of the partnership agreements, FPS provided the board with a report that summarized expenses charged

to partnerships by the general partners. FPS recommended further investigation of a partnership called the Energy Recovery Fund due to its apparent high expenses associated with legal costs.

Questions concerning partnership expenses

Also in May 1991, the *PI*, which had been following the board's activities for some time, learned that a number of partnerships, particularly three local ones, had relatively high expenses. The three local partnerships are Pierce Nordquist Partners, Phoenix, and Phoenix II. In an article about the partnerships, the *PI* noted that "the board does not know if any of the expenses it has paid these venture capital firms are justified."[4] The article also pointed out, contrary to assertions of SIB staff, that the audited financial statements of the partnerships should not be considered proof that expenses are justified.

Little review of $2 billion in assets

Shortly after the *PI* article was published, the consulting firm of Deloitte & Touche completed an organizational and operational review of the SIB that had been commissioned in May. Deloitte & Touche reported that no one at the SIB supervised or monitored the nearly $2 billion in venture capital and LBO investments. The consultant also mentioned that there were no formalized due diligence procedures[5] for these investments, nor had previous legal reviews of agreements always been adequate. In some instances there was no evidence that a legal review had taken place.

A State Auditor's report, completed in February 1992, found that management fees for LBO and venture capital investments were not being reviewed by the SIB for agreement with contract terms; and that in any case, ambiguous terminology in the contracts would make such a review difficult to do.

Note: Two other major issues involving alternative investments have received publicity but are not addressed in this performance audit. One issue concerns allegations that SIB employees may have used insider information for personal gain through stock purchases

[4] *Seattle Post-Intelligencer*, August 6, 1991.

[5] Due diligence is a standard for evaluating whether to make an investment. This standard may be different for different kinds of investments, e.g., direct investments and partnerships. Generally, due diligence includes a review of legal responsibilities and rights and the risks involved in the investment.

of companies invested in by venture capital partnerships. In turn, it has been suggested that the partnerships and companies providing the information may have been favored as a result. The second issue concerns allegations that the LBO firm, KKR, assisted Michael Milken of Drexel Burnham Lambert to obtain equity in KKR acquired companies at the expense of KKR's limited partners.

The issue of alleged insider trading is being investigated by the Office of the Attorney General. The allegations concerning KKR and Michael Milken are the subject of an ongoing legal suit filed by and on behalf of the beneficiaries of the Washington and Oregon pension trust funds.

LBC STUDY OBJECTIVES

From our preliminary review of alternative investments, we learned that until very recently no one on the board or its staff has had a very good understanding of the various partnership and LBO agreements, nor had anyone monitored these agreements. This is now changing because the board has hired an alternative investment consultant. Our overall objective was to determine whether the potential for problems that is suggested by lack of understanding and monitoring has been realized.

Have potential problems been realized?

As part of this study we reviewed all twenty-three venture capital limited partnership agreements and a sample of LBO fund agreements. We also reviewed the work that the SIB's consultants had done on KBA Partners and the Energy Recovery Fund. For our detailed examination of partnership expenses and accounting, we limited our review to the three partnership fund groups that are located in this state. Two of these, Pierce Nordquist and Phoenix, had previously been cited as having relatively high expenses.

FINDINGS

Financial Relationships of Partnership Agreements

The reports by FPS and Deloitte & Touche raised concerns with the lack of legal review of partnership agreements. A particular concern of the SIB, which was one reason for hiring FPS, was to protect the legal rights of the limited partners in these agreements. We share these concerns, and have reached the same conclusion that formerly, in many instances, legal review of these agreements was not sought. However, instead of focusing primarily on the issue of legal review, we broadened the focus to include the financial or business relationships of the agreements. We found that in this area, too, analysis and review was lacking. This section of findings explains why and how this lack of attention to financial relationships has created problems.

Analysis and review of financial relationships was lacking

Limited Partner Protections

In all of the SIB's alternative investment partnerships, the SIB is a limited partner. The main function of the limited partners is to contribute cash to the partnership. The main function of the general partner is to invest the cash. In return for providing this service to the partnership, the general partner receives an annual management fee, is reimbursed for certain expenses, and receives a percentage of profits before they are apportioned to the partners. This percentage is usually called the general partner's "carried interest." The amount of the remainder that partners receive (including the general partner) is usually based on their percentage of contributed capital. Management fees for general partners are usually between 1.75 and 2.5 percent of committed capital,[6] and carried interest is usually between 15 to 20 percent of net gains. In most cases, general partners contribute at least 1 percent of the partnership's capital.[7]

[6]Committed capital is the amount that each partner has obligated itself to be made available to the partnership for investments. Contributed capital is the amount that has actually been paid-in up to a given time.

The benefit of having general partners contribute capital to a partnership is that it helps to ensure that the general partners' interests are similar to those of the limited partners. Through this participation, all of the partners share in gains and losses. Another way to help ensure that the interests of all partners are similar is to include what are called "look-back" provisions in the agreements. The basic purpose of such look-back provisions is to make sure that throughout the course of the partnership, and at termination, the general partner receives its carried interest on *net* gains only. For example, if losses were to equal gains, and the partnership thereby breaks even, the look-back provisions would ensure that the general partner would not receive any carried interest (or at least would pay back any carried interest).

Protections vary in partnership agreements

We found that the SIB's venture capital agreements fall along a continuum in the degree to which they protect the interests of the limited partners. At one end of the continuum are agreements such as those in the Cable Howse (CH) Funds,[8] which provide many protections. The other end is occupied by agreements in which protections are weak or are virtually absent. Three of the partnership funds that have particularly weak protections are also three of the funds we had an opportunity to examine in detail.

Within Phoenix II and III,[9] whose total fund commitments are $25 million and $45 million respectively, the general partner has contributed only $5000 to each partnership in the form of an interest-bearing note. On $45 million, $5000 is about one one-hundredth of one percent. At the same time, because these partnerships lack effective look-back provisions, the general partner is in a position to realize gains even though the partnership as a whole breaks even or loses money.

[7]According to the SIB's alternative investment consultant, Brinson Partners, a minimum of 1 percent capital contribution by general partners is an industry standard. Also, the standard range for general partners' management fee we have cited is consistent with Brinson's experience.

[8]The SIB is a limited partner in two Cable Howse partnerships: CH Partners II (commenced 1981), with committed capital of $36.5 million of which the SIB's share is 8.2 percent; and CH Transition Fund (commenced 1983), with committed capital of $26.1 million of which the SIB's share is 19 percent.

[9]These two partnerships commenced in 1985 and 1987, respectively. The SIB's shares of the partnerships are 60 percent and 55.5 percent, respectively.

The first of the three Phoenix funds[10] originally had a look-back provision in the form of an escrow account that would be used to make up disproportionate losses to the limited partners. In 1987,

however, an amendment to the agreement eliminated the escrow account. None of the people we interviewed, including former board members, staff and the general partner, could recall why this safeguard was removed. We could determine no benefit to the SIB derived from this action.

Protection to the SIB was removed

We were interested in knowing whether past or current fund performance might explain or justify why some agreements are more favorable to the general partners than others. From our review of returns and from what we have learned about how general partners were selected, we found no ties to performance or any other objective criteria. Moreover, we found that the SIB has no policies or procedures for selecting individual venture capital investments. Another possibility we considered was that the SIB might have been in a weak bargaining position in some cases because it would have a minority of funds committed to a partnership. We found, however, that some of the agreements that are least favorable to the SIB are ones in which the SIB has made the majority capital commitment.

No clear reason why protections vary

We also looked at the commencement dates of the partnerships, thinking that an explanation of why some agreements provide so little protection might be because they were state-of-the-art at the time. We found this not to be the case. One of the earliest funds, CH II (May 1981), has a model agreement for providing protections to limited partners. The agreements that came after CH vary in their degree of protection, some providing like protections and some providing few protections. We could find no correlation between the degree of protections in agreements and when they commenced.

Our review of the LBO partnerships with KKR revealed some of the same kinds of lack of protection that we found in the venture capital agreements. Moreover, in the case of KKR, the structure of the

[10]The first fund is called Phoenix (no Roman numeral), and has committed capital of $16.4 million of which the SIB's share, in 1987, was 30.4 percent. This partnership commenced in 1982.

LBO fund agreements, which overlay the limited partnership agreements, exacerbates the downside risk to the limited partners. That is, losses to the SIB can exceed net losses. Here is why:

- The SIB commits its capital to an LBO fund. The fund

LBOs also lack protection

agreement obligates the SIB to enter into limited partnerships for the purpose of acquiring individual companies. KKR receives its management fee of 1.5 percent per year on the capital committed to the fund as a whole.

- Within each of the limited partnerships formed by the fund, KKR receives a carried interest of 20 percent. These agreements, however, do not contain the kind of look-back provisions that guarantee that the general partner's 20 percent will be on net gains only. This creates the same situation as in some of the venture capital agreements where the partnership could break even or even lose money but the general partner would keep some carried interest.

- Because each limited partnership is treated as a separate investment, the gains and losses among partnerships within a fund are not netted for the purpose of determining KKR's overall carried interest.

Thus, with the lack of effective look-back provisions and the fact that each partnership is treated as a separate investment, there are two ways that investors such as the SIB can receive disproportionate losses because KKR would make a profit on gross rather than net gains.

Risk/Return Analysis

In deciding whether to invest or how much to invest in venture capital and leveraged buyouts, the SIB should make a determination of the potential risks versus the potential returns. In making such a determination, it is necessary to rely on at least some understanding about how the universe of such investments have performed on average in the past, and are expected to perform in the future. In general, we found that board members were aware of the potential returns from venture capital and LBOs but not aware of the potential downside risks associated strictly with the structure of the agreements. We believe this is a cause for concern given the fact that the board has nearly $2 billion of its assets in these invest-

ments.

Venture Capital

Board members not aware of some risks

From our own review, and from our discussion with the SIB's alternative investment consultant,[11] we have found that some of the venture capital partnerships are structured so as to be riskier than the universe of such investments. To the extent this is prevalent throughout the SIB's venture capital portfolio, the portfolio as a whole might also be, on average, riskier than the universe.

Venture capital portfolio may have more risk than is usual

The two structural factors that contribute to this additional risk are lack of significant financial participation by the general partner and lack of protections of the limited partners. Minimal financial participation by the general partner can act as an incentive for the general partner to take more risk because the general partner has little or no capital contribution at risk. If taking greater risk pays off, the general partner enjoys its percentage of the gains. If taking the risk results in losses, it is the limited partners' principal that is at stake. The general partner has little or nothing to lose because it has invested little or nothing. It should be recalled, too, that the general partner's management fee is based on committed capital. The amount of the fee paid to the general partner is not affected by the performance of investments. And as previously mentioned, the lack of protections adds to risk for the limited partners because they can receive a disproportionate share of losses.

From interviews with past and present SIB members and staff, we learned that there is very little understanding of these partnership agreements. This leads us to conclude that the board generally has been unaware of the additional risk that exists in its venture capital portfolio.

[11]The SIB's use of an alternative investment consultant is a new practice that began this year.

LBOs

From our discussions with the SIB's alternative investment consultant about the KKR agreements, we have learned that the lack of protections in both the fund agreements and the partnership agreements are typical for LBOs. Therefore the particular struc-

ture of the KKR agreements do not add to the risk that might otherwise be expected for LBO investments. Nevertheless, board members are still not generally aware of this risk.

There is one additional risk, however, that may not be specific to KKR's agreements but nevertheless should be noted. As discussed above, within each LBO fund KKR can create a number of limited partnerships, which may be viewed as a way of diversifying investments and risk. Yet there is nothing preventing KKR from creating few or only one partnership, or putting most of the capital committed to a fund into one investment. In the case of the 1987 fund, KKR used $418 million of SIB funds within five partnerships, but $347 million of the total was used in the highly leveraged buyout of one company--RJR Nabisco. At the time the SIB made its cash contributions for this purchase, in 1989 and 1990, the amount of this single investment represented approximately 2.6 percent of the pension systems' funds, and 21 percent of alternative investments.

Additional risk with lack of diversification

Such lack of diversification within the 1987 fund may contribute to the potential for greater returns, but it also carries substantially greater risk. Our discussion of real estate investments in Chapter 5 provides an example of the significant downside risk of lack of diversification.

Compliance with Partnership Agreements

Allocations and Distributions

A *PI* article, referenced earlier in this chapter, asserted that audited financial reports of venture capital partnerships provide no guarantee that expenses charged by general partners are in accordance with the partnership agreements. We not only found this assertion to be correct concerning expenses (see the Expenses section, below), but we also found that the audited financial reports provide no guarantees about the allocation and distribution of partnership assets and proceeds. We found several instances where a general partner has made allocations and distributions that we would question:

Annual financial reports provide no guarantees

- In the Phoenix II and Phoenix III partnerships, the

general partner has not netted losses and gains that have occurred in the same fiscal period. In the two cases we found, the losses were realized after the gains. This means that the partner received carried interest on gross proceeds rather than on net proceeds.

Our understanding of the agreements, and the understanding of the LBC's AAG who has also reviewed these agreements, is that losses and gains that occur in the same period must be netted.

Examples of questionable practices

- In all three Phoenix partnerships the general partner has reinterpreted the agreement and changed the basis on which allocations to partners' accounts are made.

  Neither we nor the LBC's AAG could find any language in the agreements that would support such a change.

- According to documents provided by the general partner, the general partner of Phoenix took a distribution based on a calculated price per share of stock rather than the actual price when sold. The calculated price was higher.

  Neither we nor the LBC's AAG could find a basis in the agreement for a distribution based on calculated price rather than actual sales price.

- On another occasion the general partner of Phoenix realized a gain by not recognizing a then-current loss in the valuation of assets.
  Our understanding of this agreement, and the understanding of the LBC's AAG, is that when gains are allocated, which is supposed to be at the end of a fiscal period, the general partner must take into account the valuation at the end of that (then-current) fiscal period.

The total amount of capital involved in these actions was approximately $400,000, which otherwise would have been allocated to the limited partners.[12] Of particular concern to us, since we question these actions, is the potential for greater amounts to be at issue in the future.

We have submitted these matters to the SIB and its legal counsel for further investigation.

These questions merit further investigation

NOTE: We learned of these actions because we replicated how the three Phoenix agreements worked, and we reviewed detailed accounting information not found in the annual reports. The annual audited financial statements that were provided to the SIB by the general partner did not explain any of these interpretations or actions, even though in some cases the actions had the effect of changing the general partner's and the limited partners' account balances.

Annual financial reports did not explain questionable actions

Partnership Expenses

In the discussion of previously disclosed issues, it was indicated that the audited financial statements of partnerships should not be considered proof that expenses are contractually justified. In order to ascertain whether the lack of monitoring of expenses had any consequences to the SIB, we reviewed the terms of all the partnership agreements and the expense records of the following funds: the two Cable Howse partnerships, the three Phoenix partnerships, and Pierce Nordquist. We chose to review the expenses of these partnerships because they are all located in Washington State. From this review we found a general problem as well as some specific problems. These are detailed below.

[12]The years in which accounts were affected by these actions are 1987, 1988, and 1989.

Vague Contract Language

The State Auditor found that some investment contracts contain vague and unspecific terms for computing management fees. We concur, and we also found that some contracts contain vague and even contradictory language regarding organizational (start up) and operational (ongoing) expenses.

For example, some agreements put a cap on organizational expenses whereas others do not, and some agreements do not even define organizational expenses. We also found that different partnerships may have similar language as to what chargeable operational expenses are, but interpret the language differently. Because of this vagueness, we were unable to conclude, on a case-by-case basis, that any one interpretation was more accurate than another. This puts the SIB in a position where it sometimes pays for expenses for one partnership that are not charged by another, even though the language concerning expenses in each partnership may be similar or the same.

Agreements unclear as to basis for expenses

Specific Problem Areas

Phoenix funds

From our review of the Phoenix funds' expenses we found that the Phoenix and Phoenix II partnerships had together incurred legal and settlement costs totaling over $900,000 in relation to a wrongful termination suit. These costs were charged to the partnerships as expenses from 1987 through 1989. This suit was brought by a former employee of the general partner whose employment contract with the general partner entitled him to a portion of the general partner's carried interest. The defendants named in the suit by the plaintiff were: the managing general partner of the partnership and his wife; the general partners and the partnership management firm; and the limited partnerships, which included the SIB. All of the costs related to this suit were paid by the partners in proportion to their contributed capital, although the managing general partner was solely responsible for the employment decision that led to the lawsuit.

$900,000 lawsuit charged to partnership

Based on our discussions with past staff and board members, we were told that the voting members of the board were never informed about these expenses. However, one former non-voting member and a former executive director said that they knew about the lawsuit. The AAG who represented the board at the time does not recall having been asked for advice on this matter. Throughout the lawsuit all of the parties named in the suit were represented by the

same private legal counsel hired by the general partner.

Voting board members were not informed

We have concerns over how the interests of the State's pension fund beneficiaries were represented in this matter:

- The SIB voting members should have been informed of the lawsuit and the potential expenses.

- We believe that the board, or those representing the board, should have obtained separate legal advice on how to best protect the SIB's rights in the lawsuit.

Interests of beneficiaries may not have been adequately represented

- Since the various defendants in the lawsuit may have had different interests at stake, there was at least the potential for a conflict of interest by having all parties be represented by the same law firm, which in this case was hired by the general partner.

Given these concerns, we question whether the individuals acting on behalf of the board were adequately representing the interest of the pension fund beneficiaries.

Pierce Nordquist

We observed another problem in the expenses charged by Pierce Nordquist Partners (PNP).[13] This problem relates to the amount of expenses charged to the partnership for costs incurred prior to the start of the partnership. Between August 1983 and the partnership commencement date of May 6, 1986, the general partner

[13]This partnership has aggregate committed capital of $17.6 million of which the SIB's share is 85 percent.

incurred $417,000 in costs that were later charged to the organizational expenses of the partnership. This amount is beyond the standard for a fund the size of PNP's.[14]

One of the general partners had been a pro bono advisor to the SIB on venture capital investments during the board's first few years in the early 1980s. At one point the board considered hiring, but did

not agree to hire, this person as a consultant. It was not until 1984, however, that board minutes reflect any discussion of a PNP investment. In 1985 the board was still just considering the possibility. According to one of the general partners, the SIB was never informed that costs going back to 1983 would be charged to the partnership.

Non-standard organizational expenses

After the commencement of the partnership in 1986, the SIB executive director raised issue with the amount of organizational expenses and asked for a reduction. This individual informed us that he did not know the details of what was included in the amount. In response, the general partner agreed that the first $510,000 of gain at liquidation of the partnership would go to the limited partners. In effect, this would amount to a refund of $102,000 (the general partner's 20 percent) to the limited partners *provided* there are gains at liquidation. With a termination date of 1996, the value of the $102,000, assuming it is realized, is actually less because of the time-value of money. This value would be about $31,000 assuming a discount rate of 12.6 percent, which is the return the SIB has received on its investments since 1986. According to the former executive director, board members were not informed about these expenses.

[14]According to the SIB's alternative investment consultant, organization costs can now run as high as $200,000 to $300,000, due in large part to the legal costs of organization. Thus the $417,000 in PNP's organizational costs, which were incurred between 1983 and 1986, would be high even for today. Based on our knowledge of organizational costs of the other venture capital partnerships in the SIB's portfolio, we would have expected PNP's organizational costs to be in the $40,000 to $75,000 range.

We are not suggesting that the $417,000 in expenses were unrelated to partnership formation.[15] Nevertheless, neither the board nor its executive director were informed that expenses going back to 1983 would be charged to the partnership, the details of the expenses were unknown to the SIB, and there is no guarantee that any of the negotiated reduction will ever be realized. For these reasons we believe that the SIB should seek further renegotiation of these

organizational costs.

SIB should renegotiate expenses

We have referred this matter to the SIB for appropriate action.

Potential Conflicts of Interest

Owing to the lack of protections in some of the agreements, general partners can make decisions that will be to their financial benefit at the expense of the limited partners. An example of this would be the decision to delay realizing a loss until after the proceeds from a gain have been distributed, thereby allowing the general partner to take gains on gross proceeds rather than net proceeds.

Potential conflicts may be at odds with beneficiaries' interests

We question whether the SIB can adequately represent the interests of its pension plan beneficiaries by entering into such agreements, and then by not monitoring expenses and allocations and distributions.

ACTIONS BEING TAKEN BY THE SIB

The SIB has hired an Alternative Investment Consultant who is now providing general oversight and monitoring of venture capital and LBO investments. This consultant is currently reviewing existing investments and will be developing policies and procedures for screening and evaluating future investment opportunities. For these future investments, the consultant will analyze financial relationships and attempt to negotiate necessary protections.

Expert consultant hired

[15]We have provided the SIB with a breakdown of the expenses by categories and by dates incurred. The SIB now has a better basis for reviewing the individual expenses with the general partner to determine if they are in accord with the agreement.

The SIB is also planning to hire a senior investment officer who will review existing agreements to determine actions that can be taken to eliminate ambiguous language and establish procedures for validating management fees.

All contracts are now being reviewed by the Office of the Attorney General, or other authorized legal counsel to the board, prior to execution.

RECOMMENDATIONS

Staff will be added

We have referred some of the issues and concerns raised in this chapter to the SIB, and to the AAG assigned to the SIB, as appropriate. We have been advised by our own legal counsel that there is no provision in State statute for the LBC to make direct referrals of audit issues and concerns to the Attorney General's Office, because the Attorney General has no independent statutory enforcement authority with respect to LBC audit recommendations.

Recommendation 1

The procedures being developed by the SIB's alternative investment consultant for screening and evaluating future investments should take into account the several problem areas identified in this report. These problems include:

- ***Lack of general partner financial participation***
- ***Fees unrelated to performance***
- ***Situations where the SIB has a disproportionate amount of the risk***
- ***Situations where the general partner's carried interest can be on gross rather than net gains***
- ***Vague and open-ended contractual language***
- ***Lack of caps or other specific limitations on expenses***

Recommendation 2

In addition to validating management fees, the board's

senior investment officer should establish procedures to validate expenses and to ensure that allocations and distributions are made and have been made in accordance with partnership agreements.

Recommendation 3

The SIB should avoid making investments or entering agreements that involve actual or potential conflicts of interest on the part of managers, contractors, and partners. Toward this end, the SIB should establish procedures for: identifying potential and actual conflicts of interests in proposed investments and agreements; ensuring that all board members are formally notified of such conflicts; and requiring that such notification is reflected in board minutes.

PERSONAL SERVICES CONTRACTS

Chapter Four

Previously disclosed issues

In the Fall of 1991 OFM took issue with a $3.4 million, five-year personal services contract entered into by the SIB in January 1991 and submitted to OFM in June. The consultant, who is the managing partner of the Phoenix partnerships, was to be paid $750,000 the first calendar year and $650,000 each calendar year thereafter to provide a review of the domestic investments of KBA Partners. The SIB's total commitment to two KBA limited partnerships was $78 million.

There were several problems that OFM had with the issuance of this contract:

- The contract was not competitively bid.
- The terms of the contract were highly unfavorable to the SIB. Specifically, if the SIB terminated the contract, it was obligated to pay the contractor the current year's and following year's portions of the $3.4 million.
- The SIB claimed the contract was entered into under emergency conditions but failed to submit the contract for OFM review within the statutorily mandated time frame. Further, the documentation provided by the SIB did not explain why a five-year contract was needed for an emergency situation.

In response to OFM's concerns, the SIB provided an explanation of why a short-term emergency situation had existed and agreed to renegotiate the contract under more favorable terms by eliminating the second-year payout. The SIB terminated the contract at the

end of 1991 after paying the consultant $750,000.

Contracting practices have not followed state law

The SIB's failure to follow statutory rules for the $3.4 million personal services contract has been highlighted in several press articles. Partly in response to this issue, SIB's organizational and operational consultant, Deloitte & Touche, included in its September 1991 report a recommendation that the SIB comply with OFM regulations. Subsequently, a State Auditor's report, completed in February 1992, noted that the SIB had entered into other noncompetitive contracts that have either not been filed with OFM or have been filed after the performance of the contract has already begun, and beyond the time-frame established by law.

LBC STUDY OBJECTIVES

Our preliminary review of the SIB's practices in awarding personal services contracts indicated that the problems of noncompliance with state statute and OFM regulations have extended beyond the one instance detailed above. The State Auditor's report stated a similar conclusion and concern, but did not cite specific examples. Our objectives in reviewing this area were to understand the nature and extent of problems in the contracting process, to explain to the legislature the possible ramifications of these problems, and to assess and report on the actions being taken by the SIB to address them.

FINDINGS

SIB officers and contractors may be subject to penalties

Prior to the Fall of 1991, in only isolated instances did the SIB follow state law in issuing personal service contracts. In many cases contracts were not competitively bid, consultants began to work on projects before contracts were signed, and emergency and sole-source contracts were not filed with OFM until well after they were required to be filed. In some cases contracts were never filed with OFM. As stated in the State Auditor's 1991 report: "Circumventing state statute allowed the agency to expend funds for contracts that had not been approved and subjected SIB officers and contractors to potential civil penalties."

Since the Fall of 1991 the SIB has generally been following a process

aimed at ensuring that personal services contracts are awarded in accordance with OFM regulations. In most cases the board is now issuing Requests for Proposals (RFPs), is competitively rating candidates, and is meeting OFM filing requirements. The major, new consulting services[1] recently retained by the board were procured through this process.

SIB has improved practices...

Although the current process is a significant improvement over past practices, two problem areas still warrant corrective action. One concerns the board's degree of effort to ensure competition on routine contracts, and the other pertains to how the board has been using contracted legal services. In our discussion of these two areas below, a central issue we will raise concerns the board's lack of adherence to the intent of state law. RCW 39.29.003 states that the intent of the Personal Service Contracts law is to "establish a policy of open competition for all personal service contracts entered into by state agencies...."

but some problems remain

Competition on Routine Contracts

In the course of this audit we observed two questionable instances of the board not making enough effort to ensure that there was a competitive process for routine contracts.

More effort needed to ensure competition

One occurred in 1991 when the contract with the consulting firm of Deloitte & Touche, for the organizational and operational study mentioned above, was amended to include an information system implementation project. The original contract amount had been for $80,000 (later adjusted upward by another $25,000). The new, amended contract for the information system project was for $162,000. OFM regulations allow for contract amendments in the event of scope changes. In our view, the implementation project went beyond a scope change and amounted to a separate project. This project was suspended by the new executive director soon after he was hired.

It should be noted that the information system implementation project grew out of a recommendation from Deloitte & Touche's

[1]These services include: pension consultant, alternative investment consultant, real estate consultant, and real estate asset manager.

originally contracted study. The fact that the consulting firm that

recommended the project received a contract for the project, without a competitive process, raises conflict of interest issues. The matter of consultants being eligible for follow-on work from their own recommendations is discussed further in Chapter 5, Real Estate Investments.

The second instance occurred this year when the board sought a sole-source exemption from the competitive process for a consultant to provide training on fiduciary responsibilities. RCW 39.29.006(10) defines sole source as "professional or technical expertise of such a unique nature that the consultant is clearly and justifiably the only practicable source to provide the service." In this case the desired consultant was not the only professional having such expertise. OFM was not at first aware of this and only became aware after being notified by the LBC. Subsequently this project went out for bid.

We recognize that judgments may sometimes vary over the circumstances for when amendments and sole-source contracts are justified. Nevertheless, the view of OFM, which was communicated to the SIB, is that the absence of qualified competitors under most circumstances is rare. In the two instances cited above, the board should have made greater efforts to seek out competition for these services in advance of filing their requests with OFM.

Legal Services Contracting and Subcontracting

Background

Law firm's initial work was limited in scope

In November 1990 the SIB sent out an RFP asking for a fixed price bid for legal counsel to advise the board on venture capital and other limited partnership agreements. The RFP specifically mentioned 21 partnership agreements with eight general partners. The law firm of Foster Pepper and Shefelman (FPS), which had submitted a bid of $70,000 exclusive of expenses, was selected by the board. The two other bids that the board was able to locate and provide to us were each for $5,000. The notice of the award of a contract to FPS was made on February 6, 1991, although the law firm had begun work earlier. For instance, on February 1, the firm acted on behalf of the board to engage the services of a British investment consulting firm, S.G. Warburg & Co. Ltd., to review the financial position of a troubled foreign investment of KBA Partners, a venture capital

partnership. The cost of this investment review was $.5 million. Warburg's contract was not competitively bid, and was not submitted to OFM as an emergency contract until four months later. State law requires that emergency contracts be filed within three days of execution or commencement of work.

The board did not enter into a formal contract with FPS until May 13, 1991. The allowable contract amount was $.5 million. In addition to the venture capital review, the scope of this contract included reviews of proposed agreements concerning Kohlberg Kravis and Roberts (for investment in a leveraged buy out), Two Union Square (a real estate loan), and "other matters as determined by the Board."[2] By May 13, however, the original venture capital review was largely complete. This contract was not submitted to OFM. It expired on December 31, 1991.

Work expanded to broad scope and $4 million

On January 30, 1992, the board submitted a request to OFM to amend the expired contract and to increase the allowable cost from $.5 to $4 million. The four million was to cover a number of subcontracting expenses already incurred by FPS and to continue work in progress. Some of the previous work and the work in progress included providing general legal counsel to the SIB.

In our discussions with the board on this matter we raised the concern that the $4 million contract, which covered a broad range of work efforts and included general legal counseling, went far beyond the scope of work that was originally competitively bid. Our finding, which we shared with the board, is that there was not a competitive process for the resulting breadth of services being provided by FPS. We agree with the representatives of the board who have argued that the SIB had good reasons for many of the work efforts contributing to the broader scope. As examples, the board had a commitment of $78 million to KBA partners, and had another $220 million invested in Two Union Square in the form of a loan. These were significant investments that needed to be protected. Nevertheless, none of the situations the board found itself in required that it circumvent state statute.

Resulting contract was not competitively bid

[2]This did not include the $.5 million contract with the British investment firm.

Since FPS began working for the board, the firm has acted as a general contractor at least five times to our knowledge. The subcontractors have included:

- S. G. Warburg & Co. Ltd., for analysis of a venture capital investment;
- Lowe Enterprises, for analysis of the Two Union Square loan restructure;
- Northcoast Mortgage for an analysis related to One and Two Union Square;
- Deloitte & Touche, for business review of a venture capital partnership; and
- Shearson Lehman Brothers, Inc., for an analysis of the Prentiss/Copley real estate investment.

Altogether the allowable costs of these subcontracts exceed $3 million.[3] A concern we have with this process of subcontracting through a law firm is that in no instance did the firm or the board follow the formal, competitive process contemplated in Chapter 39.29 RCW, or go through the review process for non-competitive contracts. When we discussed this matter with board representatives we were referred to communications between FPS and OFM regarding an agreement whereby FPS, in retaining subcontractors, would not have to follow the competitive bid process and other contracting requirements. This understanding between OFM and FPS related to hiring and retaining "experts to assist in...legal analysis."[4]

Competitive process not followed for subcontractors

In our discussion with OFM representatives, they told us that their understanding of what was meant by "experts to assist in legal analysis" did not include the kind and extent of work that was eventually subcontracted; and had they known this, they would

[3]The $.5 million for the Warburg contract, which has already been paid, is not included within the $4 million allowable for FPS.

[4]Letter from FPS to OFM dated August 20, 1991.

have advised FPS and the SIB to hire the subcontractors through a formal, competitive process. OFM's view was that hiring subcontractors through a formal, competitive process would have been desirable, but would not have been required under the law, so long as the general contractor had been hired through such a process.[5]

As explained above, the breadth of services being provided by FPS had not been competitively awarded, and therefore did not comply with statute. Although this in itself is cause for concern, the way the board used FPS as a general contractor raises another issue: There was potential for abuse under such an arrangement because the board and FPS could procure major consulting services by any process they chose without any outside review of project scope and budget or of potential conflicts of interest. In one instance, FPS has hired one of its major clients, Shearson Lehman Brothers, Inc., as a consultant. The allowable contract amount is $2.5 million. This situation creates at least the potential for a conflict of interest on the part of FPS. Since a formal competitive process was not followed on this contract, there is no assurance that the SIB or FPS sought to mitigate this potential conflict.

Potential for abuse

Attorney-Client Privilege

In matters of potential litigation, consultant work done in support of legal analysis can be protected by attorney-client privilege. Unless the board waives this privilege, the information can be withheld from public disclosure.

We have a concern with the potential for abuse in the use of a legal firm to hire other consultants. Use of a law firm in this way could be used as a means to shield the board from accountability to its plan beneficiaries, the rest of state government, and to the public.

General Legal Counsel

In providing services to the SIB, the law firm of FPS has acted as, and has represented itself as, general legal counsel to the board.

[5]Chapter 39.29 RCW does not actually address the use of subcontractors.

According to RCW 43.10.040, however, the Office of the Attorney

General (AG) is the legal representative and advisor in all matters involving legal questions. Under certain circumstances the AG will authorize an agency to obtain outside legal assistance. Such a circumstance would be the need for specialized expertise. Authority to employ or retain attorneys to provide these services is vested in the AG under RCW 43.10.067.

The expansion of FPS's legal services to encompass general counsel functions, without the approval of the AG, was improper.

ACTIONS BEING TAKEN BY THE SIB

SIB has committed to address problems

In response to the above concerns, the SIB has informed us that it is taking steps to limit FPS's role only to matters currently in progress, and that it will not use FPS for, nor pay for, any additional general legal services. Henceforth, according to the board, all outside legal services sought by the board will have to have prior AG approval and adhere to the requirements of Chapter 39.29 RCW. It is also our understanding that the AG will be responsible for ensuring that attorney-client privilege is invoked only in specific cases where it is reasonable to assume potential litigation. The board has further assured us that its objective is to abide by the intent of Chapter 39.29 RCW regarding competition.

While we agree that these steps are necessary and appropriate, we believe that an additional corrective action is required. Unless the cost and use of subcontractors is specifically provided for in the scope and budget of a personal services contract that has been competitively bid, each proposed use of subcontractors by agencies should be filed with OFM and, if not competitively bid, be reviewed by OFM on a case-by-case basis.

RECOMMENDATION

Recommendation 4

The legislature should amend Chapter 39.29 RCW to require that subcontracts within personal services contracts be filed with the Office of Financial Management. An exception to this requirement would apply in the event that the use of subcontractors is specifi-

cally addressed within the scope and budget of an existing contract, and that such use was taken into account when the contractor was originally hired through a competitive process.

REAL ESTATE INVESTMENTS

Chapter Five

Background

The 17 real estate equity investments of the SIB are currently valued at slightly over $1 billion. This valuation is against an invested amount of almost $1.2 billion; therefore, the SIB has lost nearly $200 million on its real estate investments.[1]

Within the 17 real estate investments, there are several different investment types: investments in open- or closed-end real estate funds (shares of open-end funds are traded in an open market while shares of closed-end funds are not openly traded); participation as a limited partner in a partnership which owns a portfolio of property; participation in joint ventures with a partner who manages the property, or property that is directly owned by the SIB.

Of the approximately $1 billion (current value) of SIB equity real estate investments, approximately $47 million is in open-end real estate funds, $203 million is invested in closed-end real estate funds, $17 million is invested in joint ventures, $571 million is invested in partnerships as a limited partner, $175 million in partnerships with the SIB as a general partner, and $2 million is directly owned by the SIB (see Exhibit 3).

[1]The majority of the SIB's real estate investments were made between 1984 and 1988. During this period, the SIB invested over $700 million in real estate. The losses in the SIB's real estate portfolio have been incurred during 1991 and 1992. Prior to 1991, the SIB had shown a paper profit on these investments.

Exhibit 3

SIB Real Estate Investments

Within the various structures of the SIB's real estate equity investments, the SIB's share of the total value of the investment can range from 1 percent in the case of investments in open-end real estate funds to 100 percent in the case of certain partnerships or when the SIB has direct ownership of the investment.

Over 50 percent of the SIB's real estate holdings are managed by one advisor, Copley Real Estate Advisors of Boston. This percentage was over 60 percent until recently, when there was a sharp decline in value of several of the holdings managed by Copley.

High levels of debt

Many of the properties in the SIB's real estate portfolio are subject to large amounts of debt. Exclusive of the relatively small investments by the SIB in open-end real estate funds, the total value of the properties in which the SIB has invested is $5.2 billion. Of this amount, $3.4 billion (or 66 percent) is encumbered by debt. Owner's equity in these properties is $1.8 billion. The SIB's share of the owner's equity is $968 million, or 54 percent. Other partners own the other 46 percent of the equity in these investments (see Exhibit 4).

Exhibit 4

SIB Real Estate Investments, Debt VS Equity
Total = $5.2 Billion

PREVIOUSLY DISCLOSED ISSUES

Most of the previously disclosed issues with the SIB's real estate investments have involved either the investment in the Two Union Square office building in downtown Seattle, or the investment in the Prentiss/Copley real estate portfolio managed by Copley Real Estate Advisors.

Two Union Square loan restructure

Articles in the *PI* have mentioned that the SIB restructured its $220 million loan to Union Square Venture, the owners of Two Union Square, and has taken over ownership of the building. The *PI* articles stated that the SIB took over ownership because the building's owners were on the verge of default, and that the building's occupancy was far short of projections. The *PI* also questioned whether the building would be profitable even if fully occupied.

The *PI* has also written about the SIB's $405 million investment in the Prentiss/Copley real estate portfolio.[2] These articles have stated that the investment's value has dropped from $405 million to $256 million, and have remarked about the high amount of man-

[2]The SIB originally invested $450 million in the Prentiss/Copley real estate portfolio. Copley has returned $45 million leaving a current investment of $405 million. This is a portfolio of properties which includes office buildings, industrial parks, and raw land. The properties within the portfolio are located primarily in Southern California, Texas, and the Washington D.C. area.

agement fees that have been paid by the SIB on this investment. The *PI* has further disclosed that the SIB staff member responsible for oversight of the SIB's real estate portfolio had a personal investment in the stock of an affiliate of Copley Real Estate Advisors, and that this same staff member's travel bills were paid by the SIB's real estate managers when he visited SIB real estate holdings. That staff member subsequently resigned from the SIB.

Prentiss/ Copley real estate investment

Excerpts of a report by Shearson Capital Preservation and Restructuring, the SIB's business consultant on the Prentiss/Copley real estate investment were recently made public after a lawsuit brought by the *PI*. These excerpts have indicated that there are conflicts of interest in the fee structure of the Prentiss/Copley investment, and that Shearson has questioned Copley's valuation of some of the properties in the portfolio.

The Organization and Operations Study conducted by the firm of Deloitte and Touche found that the SIB has few documented procedures for the real estate program, that no one at the SIB verifies the calculation of real estate manager fees, and that the files for many of the real estate equity investments are disorganized.

The State Auditor's Office did not discuss any findings specific to the SIB's real estate investments in its 1991 report.

LBC STUDY OBJECTIVES

Our preliminary review of the SIB's real estate investment practices found problems that were both broader in scope and more serious than those that had been previously identified. Our objectives in reviewing the SIB's real estate investments were to understand the problems that had previously been identified and the possible ramifications of those problems, determine whether additional problems exist that had not been identified, and to assess the actions being taken by the SIB to address the problems.

Although the previously disclosed problems involved investments that had been made several years ago, these investments are ongoing and the SIB has recently made, or is making, major decisions about alternatives for addressing the problems associated with the investments. This has provided us with an opportunity to observe the current decision-making process of the SIB and to

evaluate that process.

However, we have also been denied information on the basis of attorney-client privilege concerning the most current major real estate decision facing the SIB. The information that was denied is the report prepared by FPS and Shearson Capital Preservation and Restructuring, the SIB's legal and business consultants, on the legal and business alternatives available to the SIB to maximize its investment in the Prentiss/Copley real estate portfolio. Without this report, we cannot adequately assess the SIB's decision-making process on this investment since we cannot know the basis for SIB decisions.

Information denied to LBC

FINDINGS

Our findings concerning the SIB's real estate investment practices are primarily based on a detailed review of only two specific investments. Time constraints and the extremely complex structure of the SIB's real estate investments required the audit team to restrict its detailed inquiry to these two investments, although we did a more limited review of other real estate investments. The two investments that were reviewed in detail are the $405 million investment in the Prentiss/Copley real estate portfolio (currently valued at $256 million) and the $220 million investment in Two Union Square (currently valued at $175 million). While we were unable to evaluate the current decision-making process being followed by the board on the Prentiss/Copley investment, we have several findings about the structure of this investment. We were able to evaluate the board's recent decision-making process to restructure the SIB's loan on Two Union Square.

Focus of LBC real estate review

We have several general findings about the SIB's real estate investment practices. Many of these findings are critical of practices that occurred in the past. We have also found that the SIB is taking positive steps to address many of the problems. However, we believe that there are still further improvements that should be made in the SIB's real estate investment practices.

Our findings include the following:

- There were no documented real estate investment policies and procedures.

- There are numerous examples where the interests of the SIB and the SIB's partners and/or managers in its real estate investments diverge or are at odds. In many cases, if the SIB staff was aware of these conflicts, there is no evidence that they disclosed such conflicts to the board.

Poor real estate investment practices made

- The SIB's staff analysis of proposed real estate investments was inadequate.

- The SIB has not and does not monitor fees and expenses that have been charged, or distributions of investment income.

- The investment structure for certain real estate investments is so complex that it is extremely difficult for the SIB to understand the basis for fees and expenses, or to understand whether income of the investments is being allocated correctly. The complexity of these investments also has contributed to a situation where the real estate staff do not have an adequate understanding of the investments they administer.

The SIB has improved its decision-making process concerning real estate investments but further improvements are needed.

Investment Policies and Procedures

Background

No policies and procedures exist for the SIB's real estate investments. Such policies and procedures would address issues such as diversification requirements of the real estate portfolio, the process by which potential real estate investments would be evaluated, the standards for evaluating potential real estate investments, a legal and business review of the contracts associated with real estate investments, a process for monitoring management fees, expenses and distributions of investment income, a process for evaluating real estate investment managers, and a process for determining

when to hold and when to sell investments.

Certainly, a major reason why the SIB's real estate portfolio has lost 17 percent of its value is the overall condition of the commercial real estate market. Nevertheless, we believe the absence of overall policies and procedures is a contributing factor to these losses.

No investment policies and procedures

Many of the more specific problems we will discuss about the SIB's real estate investment practices are also attributable to the lack of policies and procedures for investments in real estate. For example, had adequate due diligence standards existed and been followed for analyzing potential real estate investments, some of the problems identified in this report could have been avoided.

Following are examples of the types of issues that would be addressed by investment policies and procedures:

Diversification Policies

The use of investment policies and procedures would address diversification requirements of the portfolio to reduce the level of risk associated with the investments. There are several factors which should be considered in policies for diversifying a real estate portfolio of this magnitude. Among these factors are geographic diversification, diversification by type of property, and diversification of managers.

Lack of diversification

The lack of investment policies and procedures regarding diversification requirements may have contributed to the SIB's real estate losses. For example, over 62 percent of the SIB's entire real estate portfolio was allocated to several investments with Copley Real Estate Advisors. The value of the investments managed by Copley are now worth 72 percent of the amount originally invested. The value of the SIB's real estate investments with managers other than Copley are now worth 106 percent of the amount originally invested. Had policies existed which precluded the investment of such a large proportion of the SIB's real estate portfolio with one manager, the total performance of the SIB's real estate investments may have been better.

Process for Evaluating Proposed Investments

There are no policies and procedures to evaluate proposed invest-

ments. Without a documented evaluation process, it is impossible to determine the basis for SIB decisions.

Standards for Evaluating Proposed Investments (Due Diligence Standards)

There are no documented standards for evaluating proposed investments. For example, certain contracts provide almost no ability for the SIB to withdraw from the investment for any reason. There have often been no independent appraisals of proposed SIB real estate investments. Also, in at least one case, the SIB staff recommended, and the SIB approved, investment in a real estate partnership prior to having seen the contracts governing management fees, expenses, and distributions of partnership income. In this case, the contracts contained several potential conflicts between the interests of the investment managers and the SIB.

No standards for evaluating investments

Also, there is no documentation that the levels of risk of the various real estate investments were considered in the context of the entire real estate portfolio. As was pointed out previously, many of the SIB's real estate investments involve high levels of debt. There is no evidence that the SIB considered how the risk of the SIB's real estate investments compared to industry standards, or how the level of risk was a consideration in making investment decisions.

Monitoring Real Estate Investments

As we found regarding venture capital investments, there are no policies and procedures to monitor the SIB's real estate investments. SIB staff have not monitored investments to determine if the management fees, expenses and distributions of income are in accordance with the contracts. In some cases, the SIB does not have the information in its files needed to fully monitor the contracts.

No monitoring of investments

Evaluation of Real Estate Investment Managers

There are no policies and procedures to evaluate real estate investment managers. The SIB has made additional investments with existing real estate managers without adequate information about the performance of previous SIB investments with these managers, or how the previous contracts with these managers compared to other contracts in protecting the interests of the SIB.

Potential Conflicts of Interest

The SIB has retained Shearson Capital Preservation and Restructuring (at a budgeted cost of up to $2.5 million) to provide expert consulting advice on the Prentiss/Copley real estate investment. Excerpts of the Shearson report were recently made public after a public disclosure lawsuit brought by the *PI*. Included in the excerpts of the Shearson report was a reference to a conflict of interest in the fee structure of the Prentiss/Copley investment, in that Copley's fees are calculated as a percentage of the portfolio value. As discussed below, we concur that the Copley management fee provision creates the potential for a conflict of interest. Also, we have found several additional examples of potential conflicts of interest in the fee structure of the Prentiss/Copley investment, and other real estate investments of the SIB.

Potential conflicts may be at odds with beneficiaries' interests

In some cases, these potential conflicts of interests could create a situation where contractual incentives exist for investment managers to make decisions that are not in the best interests of the SIB. There is no evidence that the existence of these potential conflicts was made known to SIB board members when they were asked to approve specific real estate investments. There is also no evidence that the SIB staff was aware of the existence of some of the potential conflicts in the SIB's real estate investments.

We question whether the board could have ensured that prudent real estate decisions were made given the potential conflicts in the contracts between the SIB and its real estate managers.

Following are several examples of potential conflicts between the interests of the SIB and its investment managers within the SIB's real estate contracts.

Management Fees

Management fees for many of the SIB's real estate investments are based on a percentage of the value of the portfolio that is being managed. These fees are paid regardless of whether the investment is profitable. In many cases the manager is responsible for valuing the portfolio, and the manager's valuation cannot be questioned by the investors.

Also, management fees are calculated against the total value of the portfolio, including the amount of the portfolio that is leveraged. There are often no contractual restrictions on the amount of debt that can be assumed by the manager, and managers have the authority to withhold income from the properties to purchase and develop additional properties for the portfolio, and thereby increase management fees. Therefore, there are contractual incentives for the managers to incur large amounts of debt, and to purchase and develop additional properties in order to increase fees. These incentives may be counter to the interests of the investors.

Incentives to managers to increase fees

Taken by itself, the existence of a management fee which is calculated as a percentage of the portfolio value may not necessarily cause concerns that the fee creates a conflict of interest. If there is an independent process for valuing properties, and if there are controls over the manager to ensure that decisions are not made for the purpose of generating fees, then the potential conflicts can be mitigated. However, some of the SIB's real estate contracts give broad contractual powers to the manager to buy, sell, and develop properties, incur debt, and withhold investment income to purchase additional properties. In such situations, contractual incentives exist for the managers to make decisions that may not be in the best interests of the investors.

We note that the Prentiss/Copley real estate investment has such a fee structure. The SIB currently has $405 million invested in this portfolio that is currently valued at $256 million. The 1991 total value of the portfolio was approximately $1.8 billion which provides the basis for Copley's fees. Of the $1.8 billion, approximately $1.5 billion is debt and the remaining $.3 billion is investors' equity.

We further note that the SIB provided approximately 82 percent of the total amount invested in the Prentiss/Copley real estate portfolio. However, the contracts provided the SIB with only three of the six seats on an advisory committee charged to approve the annual business plans of the portfolio. Copley has two of the remaining seats and the State of Ohio pension fund has one seat. Four votes are required for advisory committee actions to approve annual business plans.

Development Fees

In some of the SIB's real estate investments, the manager has the authority to buy and sell properties, borrow money, and develop properties with very little authority for oversight by the SIB. This broad authority combined with the fee structure of the investment can result in potential conflicts between the interests of the managers of a portfolio and the investors in the portfolio.

For example, in the Prentiss/Copley investment, Copley Real Estate Advisors is the portfolio manager while Prentiss Properties Ltd. is the property manager and developer. Copley earns fees as a percentage of the total value of the portfolio. Prentiss earns property management fees, leasing commissions, and a fee of 3 percent of the "total project cost" of any property that they develop on behalf of the portfolio. "Total project cost" is very broadly defined in the contracts. This definition includes all costs of predevelopment, development, and construction, and even operating losses until the development reaches a "break even" point. Thus, Prentiss can earn fees against not only all costs associated with planning and developing a project, but also earns fees against the operating losses of a project until it breaks even.

Fee structure encourages property development

The fact that fees to Prentiss are based on a percentage of the total project cost, without constraints, creates disincentives to the developer to control project costs. The fact that fees to Prentiss also include a percentage of the operating losses generated by the development until it breaks even creates incentives to the developer to build properties regardless of their economic justification.

The portfolio manager, Copley, is responsible for approving the annual budget and development plans of the developer, Prentiss. But Copley's fees are based on the total value of the portfolio. Therefore, this contract provides an incentive for Copley to approve new construction proposed by the developer because it will increase the total value of the portfolio, even though such development may not be economically viable.

While the audit team is not in a position to question the decisions of the SIB's investment managers, we note that the first annual business plan for the Prentiss/Copley portfolio prepared by Copley and Prentiss in 1988 states that "what is abundantly clear is that the real estate industry is in turmoil with almost all markets being substantially overbuilt." We also note that since 1987, Copley and

Prentiss have sold about $1 billion in properties from the portfolio, and at the same time have developed about $1 billion in additional properties. During this time, Prentiss and Copley have earned fees totaling over $130 million while the value of the SIB's investment has fallen from $405 million to $256 million, and will possibly fall further, according to the SIB's executive director.[3]

Prentiss/ Copley developed $1 billion of properties

Termination Fee

The Prentiss/Copley investment includes a "termination fee" payable to Prentiss in the event that any or all of the properties under management by Prentiss are no longer to be managed by Prentiss. Thus, if a property is sold from the portfolio, or if the entire portfolio is sold, or if a different property manager is desired, Prentiss receives this fee, which is equivalent to 2.0 times the management fee and reimbursable costs paid to Prentiss for managing the property for the previous 12-month period. The only exception to this fee is if Prentiss is terminated "for cause," meaning that Prentiss would have to violate the terms of the agreement or commit an act of fraud, material misrepresentation or breach of fiduciary duty.

Fees create disincentives to fire property manager

This agreement provides disincentives to fire the property manager if it is not performing adequately, or to sell the portfolio, if there were a pressing reason to do so, because there would be an obligation to pay several million dollars in termination fees to Prentiss Properties. We have seen estimates that this obligation could be as much as $25 million.

Shortfall Fee

Between 1987 and 1991, the Prentiss/Copley investment included what is called a "shortfall fee" to Prentiss Properties. The shortfall fee was in addition to Prentiss's 3 percent property management fee, leasing commissions, 3 percent development fee, and termination fee. The shortfall fee was payable to Prentiss in the event Prentiss ~~spent more to manage and~~ develop the portfolio properties than was received back from fees. The only restriction on this fee was that the Prentiss expenses had to be reasonable.

[3]The SIB executive director was quoted in the April 27, 1992 edition of *Pensions and Investments* as saying that he "would not be surprised if we had to take another writedown" (of the value of the Prentiss/Copley portfolio).

This type of fee arrangement creates disincentives to Prentiss to control operating costs. Also, in the event there are questions about the validity of expenses incurred by Prentiss, it would be very difficult to prove that their expenses were not "reasonable," since in order to do so, a court would have to make the determination that the Prentiss expenses were "unreasonable." According to Copley Real Estate Advisors, over $6 million was paid to Prentiss in shortfall fees, but also according to Copley, Prentiss has since reimbursed those fees. We note that Copley loaned Prentiss over $3 million in portfolio funds at approximately the same time the shortfall fee was reimbursed.

Fees create disincentives to control costs

The audit team asked for documentation of the operating costs of Prentiss Properties in order to assess whether these costs were reasonable, which was the test of whether they were eligible for reimbursement under the shortfall fee. For example, we noted that Prentiss spent over $4 million on "travel and entertainment" between 1987 and 1990. This amount was over $1 million, or 33 percent in excess of the budgets for these items in the annual business plans. No information about those costs was ever provided by the SIB, its legal or business consultants, or Copley and Prentiss. We only received a response to this question from Copley. They indicated that since Prentiss has reimbursed the shortfall fee, the question is not relevant.

No documentation of costs provided

We asked for documentation of the contractual authority for Copley to loan Prentiss over $3 million from portfolio funds, the loan terms, and the schedule for repayment of the loan. No information has been provided.

Investment Structure

The investors in the Prentiss/Copley portfolio include the pension funds of the State of Washington ($450 million) and the State of Ohio ($50 million). The parent company of Copley Real Estate Advisors, The New England Mutual Life Insurance Company, has also invested $50 million in the portfolio. But the investment is structured so that the investment by The New England is not subject to Copley's management fees. Therefore, the public pension funds pay a disproportionate share of the management fees. This structure provides disincentives for the manager to control management fees, since the investment by the manager's affiliate is not

subject to those fees.

Co-investment by Copley affiliate not subject to management fees

Management of Competing Properties

Some of the SIB's real estate contracts give express permission to the SIB's managers to also manage properties which may directly compete with the properties managed on behalf of the SIB. These may include properties in which the manager has a greater ownership interest than the properties managed on behalf of the SIB. This could create incentives for the manager to favor properties which directly compete with the properties in which the SIB has an interest.

Tax Issues

SIB real estate contracts allow for depreciation to be deducted as an expense against the operating income generated by the properties in the real estate portfolios. The deduction of depreciation against operating income could reduce the amount of income that could be distributed to the SIB. As a public pension fund, the SIB does not pay income taxes to the federal government on its investment earnings. Therefore, deductions of depreciation are of no benefit to the SIB, and can reduce the amount of income that would otherwise be distributed to the SIB. However, in many of the SIB's real estate investments, there are taxable entities which are either co-investors and/or managers that do benefit from deductions of depreciation. Therefore, claiming depreciation as an expense could benefit the taxable entities at the expense of the SIB.

Investment managers may benefit at the expense of the SIB

We do not know, and the SIB does not know, the extent to which tax issues may benefit the SIB's managers and co-investors in real estate investments, or to what extent the tax benefits accruing to the managers and co-investors is at the expense of the SIB.

Inadequate Staff Analysis of Proposed Real Estate Investments

SIB staff analysis of proposed real estate investments often did not include an independent appraisal of the value of the properties which were under consideration. In some cases, SIB staff attempted

to verify property values using the income approach.[4] This required SIB staff to make judgements about the economics of various real estate markets around the country. Also, there is no evidence that SIB staff attempted to utilize other standard appraisal techniques (comparable property approach, replacement cost approach). Given the magnitude of the SIB's real estate investments, it would seem prudent to secure professional, independent appraisals of proposed investments.

No independent appraisals

There is little evidence that the SIB sought legal or business review of real estate contracts by the AG or outside consultants. Also, the SIB committed to investing $450 million with Prentiss/Copley without either the staff or board members having seen the contracts which govern the investment. These contracts were not produced until after the SIB had committed to the investment.

While the SIB staff's 1987 report recommending investment in the Prentiss/Copley portfolio mentioned the management fees that would be earned by Copley, the report made no mention of the management and development fees and cost recoveries that would be earned by Prentiss Properties, or the apparent conflicts of interest in the fee structure. The Prentiss fees and recoveries have amounted to over $100 million since 1987.

Lack of legal review

The SIB staff's 1987 report on the Prentiss/Copley investment proposal estimated an expected annual return on investment of over 16 percent. This estimation was based upon Copley's projections of the average of returns for each property within the portfolio. However, these projections did not account for the impact of Copley's fees, or sharing of profits with Prentiss and Copley, and therefore overstated the potential real return to the SIB.

[4]The three standard appraisal techniques are to estimate value using: the property's estimated income; the value of comparable properties; and the estimated cost of replacing the property.

Also, the projection of an overall return based on the average of the return of the individual properties overstated the actual return to the SIB since the amount invested in the Prentiss/Copley portfolio was over $100 million in excess of the cost of purchasing the portfolio. The additional funds were used to reduce debt on the properties, and to provide working capital, which in turn, provided

funds to pay fees to Copley and Prentiss. Since the cost of acquiring the Prentiss/Copley portfolio was less than the total investment, calculating an overall return by averaging the returns earned by each individual property overstated the overall return.

Errors in projecting investment return

The Prentiss/Copley portfolio carried a high level of risk because of high levels of debt and because much of the portfolio was raw land (which is a riskier investment than developed properties). While the 1987 SIB staff report to the board mentioned these factors, it did not quantify the risk associated with the amount of debt or the amount of the portfolio that was raw land, but simply referred to these as a "disadvantage of the portfolio."

Complex Investment Structure

Complex Investment Structure and Contracts

The SIB's equity investments in real estate partnerships involve structures and contracts that are very complex and in some cases inordinately so. For example, the Prentiss/Copley investment structure contains several different tiers and involves various companies, partnerships, and joint ventures (see Appendix 3). There are several contracts which govern the financial relationships between the various entities and which specify the amounts of fees and expenses, which entity pays the fees and expenses, and how investment income is distributed. While there are various tiers in the investment structure involving numerous companies, partnerships, and joint ventures, there are actually only three investors, the SIB (82 percent of the invested amount), the State of Ohio pension fund (9 percent), and the New England Mutual Life Insurance Company (9 percent).

As we did in our investigation of venture capital investments, the audit team attempted to build spreadsheet models of various real estate contracts in order to determine whether fees, expenses, and allocations and distributions of partnership income is in accordance with the contracts. Because of the complexity of the Prentiss/Copley contract, we were not able to completely model its terms. Therefore, we were unable to determine whether the accounting of the investment is correct.

While we were unable to construct such a model, we have seen no

evidence that the SIB or its consultants has determined that the accounting of the Prentiss/Copley real estate investment is in accordance with the contracts. We have asked the SIB and its consultants to provide us with such a determination but they have not done so. In response, the SIB and its legal consultants have indicated that it would be very time consuming and expensive to verify the financial history of the Prentiss/Copley investment.

No independent verification of fees and expenses

Staff Understanding of the Contracts

We have found several instances where the SIB's real estate staff do not have a full understanding of the contracts they administer, and are trying to negotiate to maximize the investment and to improve the terms to benefit the SIB. In addition to the inability to verify the financial history of real estate investments, we found that the staff are not fully aware of the implications of tax issues on the various entities involved in the SIB's real estate investments. We believe that in order to negotiate effectively, it is important to understand the position and financial interests of the other parties to the negotiations.

We note that the SIB's senior real estate staff member was recently hired and has not yet had a chance to thoroughly review all of the SIB's real estate contracts. The SIB's real estate staff have had to spend considerable effort in dealing with problems with investments that were made before the current real estate staff were hired. Additionally, a legal review of SIB real estate contracts is being conducted by the AAG representing the SIB.

Monitoring of Real Estate Investments

The contracts governing the SIB's real estate investments specify how management fees and expenses are calculated and how investment income is divided among the investors. We found that the SIB does not monitor fee and expense charges, or distributions of income. In some cases, the contracts are so complex that it is very difficult to effectively monitor them. Also, in some cases, the SIB did not have the information, such as financial statements, in its files which would be necessary to monitor the contracts.

The potential magnitude of this monitoring problem is immense. For example, Copley and Prentiss have earned more than $130

million in fees and cost recoveries between 1987 and 1991 to manage just one of the SIB's 17 real estate investments. In addition to fees, there are expenses and calculations of income distributions that were not and are not being monitored.

No financial monitoring of investments

In a letter to LBC staff, SIB staff stated that in the past, the SIB has relied upon the investment managers' role as fiduciaries to the SIB to be responsible for the oversight of the SIB's investments. The letter also stated that the SIB intends to add staff in the future to monitor its real estate investments. From our review of both venture capital and real estate investments, we do not believe that it is prudent to rely upon the investment managers to provide complete oversight of the SIB's investments.

Also, as was stated above, the SIB is entitled to three out of six seats on the advisory committee for the Prentiss/Copley investment. This committee is charged with approving the annual business plans of the investment. The extent to which the SIB exercised this oversight authority is not clear. However, given the conflicts of interest in the contracts, the limited staff analysis of the investment proposal, and the complexity of the investment terms, the fact that representatives of the SIB may have attended oversight committee meetings does not necessarily mean that adequate oversight of this investment would have been provided.

The SIB has Improved its Decision-Making Process on Real Estate Investments, but Further Improvements are Needed

Restructure of the SIB's Loan on Two Union Square

The basis for this finding is our assessment of the process followed by the SIB to make a decision on the restructure of the SIB's loan on Two Union Square, a highrise office building in downtown Seattle. Since this was a recent decision made by the board, it is important to understand the process used to make the decision in order to assess whether the SIB's efforts to reform its operations are adequate, or whether additional changes are necessary. In order to provide a context for our findings on the SIB's decision-making process on Two Union Square, the following section will provide a history and background on the SIB's investment in Two Union Square.

Chronology of the SIB's Investment in Two Union Square

2/85 Initial proposal by Rainier Mortgage Services (subsidiary of Rainier Bank) to SIB to provide financing for Two Union Square. Under this proposal, the SIB would lend money to Union Square Venture for financing of the building. Union Square Venture is comprised of UNICO, Rainier Bank (later to become Security Pacific Bank) and Metropolitan Life Insurance. Terms are:

- Loan Amount	$154,750,000
- Interest Rate	11 3/4%
- Participation by SIB	50% cash flow after return to owner (as lender)[5]
- Loan Security	1st Deed of Trust on Two Union Square 2nd Deed of Trust on One Union Square

Initial investment proposal

11/85 SIB Staff Recommendation:

- Loan Amount	$177,000,000
- Interest Rate	10%, interest only for first 4 years
- Participation by SIB	50% cash flow after 8% re turn to owner (as lender) 50% of net sales price
- Loan Security	1st Deed of Trust on Two Union Square

[5]Participation by SIB refers to the amount of investment income that would be received by the SIB as lender over and above interest on the loan.

3/86* SIB makes loan commitment under the following terms:

- Loan Amount	$177,000,000
- Interest Rate	10% for 7 years (interest only for 4 years)

SIB loan commitment

	10.2% for 28 years
- Participation by SIB	55% cash flow after 8% re turn to owner
	60% of net sales price
- Loan Security	1st Deed of Trust on Two Union Square

7/87 Seattle *Weekly* article questioned the economics of the construction of Two Union Square. Pointed out that the building did not have an anchor tenant, something that is standard procedure for obtaining financing for office building projects.

1987 Construction commenced.

5/89* SIB approves first restructure of Two Union Square loan because of cost overruns and difficulty in attracting tenants at projected rental rates. The new terms are:

First loan restructure

- Loan Amount	$199,500,000
- Interest Rate	10% interest only through 10/90
	8% interest 11/90 through 10/94
	9% interest 11/94 through 10/97
	10% interest 11/97 through 2024
- Participation by SIB	55% of cash flow after 7% owner's return
	60% of net sales price
- Loan Security	1st Deed of Trust on Two Union Square
	2nd Deed of Trust on One Union Square

12/89* SIB approves a second loan on the property. The purpose of the second loan is to provide working capital to UNICO. The terms of the second loan are:

- Loan Amount	$20,000,000

- Interest Rate: 12.5% through 7/93; 1 Year T-Bill rate + 4.5% 8/93 through 8/96

Second loan

1989 Construction of Two Union Square completed.

1989 Metropolitan Life Insurance Company withdraws from Union Square Venture.

8/91 Union Square Venture proposes a third restructure because of financial difficulties due to inability to lease space at projected rental rates. One non-voting member of the SIB and the SIB's real estate staff made the determination to pursue restructuring the loan into a partnership with the SIB as general partner. On behalf of the SIB, the law firm of Foster Pepper & Shefelman retains Lowe Enterprises to review the course of action developed by the SIB representatives.

Third restructure proposal

9/91 Lowe Enterprises provides a report to the SIB recommending that the SIB restructure the SIB's loan into a partnership with the SIB as general partner, the borrowers as limited partners, and with the SIB to receive a preferred 8 percent return on the income and sales price of both One and Two Union Square. This was essentially the same approach as developed by the representatives of the SIB. Lowe recommends retaining UNICO as property manager, but also recommends that the SIB hire an asset manager to aggressively manage UNICO.

Consultant's report

The report considered other options (including foreclosure) but did not include a business plan which would provide an analysis of the economic value of all options, including foreclosure or gaining control of the property and selling it. Foreclosure is described as the alternative of last resort since the borrower would oppose foreclosure and might threaten or place the venture in bankruptcy, increasing legal costs and extending the date when the SIB would gain control of the property.

10/91 Lowe Enterprises and Foster Pepper & Shefelman sign a contract retaining Lowe to conduct the analysis which has previously been presented to the SIB.

10/91* SIB approves the restructure of the Union Square Loan into a partnership with the SIB as general partner. Negotiations between the SIB and Union Square Venture begin.

SIB approval of restructure

11/91* SIB approves an agreement with Union Square Venture which provides that the SIB will provide the funds to Union Square Venture to meet its financial obligations (loan payments and tenant improvement costs) while the restructure is under negotiation.

1/92* The SIB hires Lowe Enterprises as the asset manager to manage UNICO as had been recommended by Lowe. The contract pays Lowe $250,000 per year, plus .25 of 1 percent of the SIB's share of the sales price if the asset is sold. The contract terminates on 6/30/95.

3/92* The SIB approves a restructuring agreement negotiated between Lowe and Foster Pepper & Shefelman, on behalf of the SIB, and Union Square Venture. The terms of the agreement are essentially the same as the approach determined by the SIB representatives in October 1991. The terms are:

SIB approval of restructure agreement

- SIB is general partner
- UNICO and Security Pacific Bank are limited partners
- SIB responsible for all ongoing operating and capital costs
- SIB's capital account in the partnership is credited for the amount of the loan proceeds that the SIB has distributed. UNICO and Security Pacific Bank initially have no balance in their

capital accounts.

- UNICO is retained as property manager
- UNICO can be fired as property manager, and UNICO and Security Pacific Bank terminated from the partnership, if UNICO does not achieve annual financial performance targets
- SIB receives a preferred return of 8 percent on invested capital
- UNICO and Security Pacific Bank share in income above the 8 percent preferred return to SIB
- UNICO and Security Pacific Bank's maximum share of returns is 40 percent of all income after the SIB has received a 10 percent return on its investment

Terms of restructure agreement

6/92 - Final agreement is still pending approval of all involved parties.[6]

* Denotes actions by the SIB.

[6]The SIB was informed at its August 1992 meeting that the first mortgage holder on One Union Square (Metropolitan Life) has not agreed to the restructure. The SIB will now pursue a deed-in-lieu of foreclosure.

Observations about the history of the Two Union Square investment

~~While the purpose of our d~~detailed review of the Two Union Square investment was to assess the current decision-making process of the SIB, there are some observations we have about the history of the investment.

- The original 1985 proposal by Rainier Mortgage (a subsidiary of Rainier Bank which was one of the borrowers) was considerably more favorable to the SIB than the actual terms of the loan approved in 1986. Rainier Mortgage originally proposed a smaller loan, at a higher interest rate, with greater security to the SIB. During the course of negotiations between the SIB and the borrowers, the terms of the loan became less favorable to the SIB than the borrowers' initial proposal.

Questionable past decision-making process

- Rainier Mortgage and its successors, Rainier Commercial Mortgage Co. and Northcoast Mortgage have been involved with the project since 1985. They have acted as servicing agents for the loan, and as analysts preparing spreadsheets for various alternatives for the SIB during each restructure. This firm, until recently was a subsidiary of Security Pacific Bank (which acquired Rainier Bank). It seems questionable for the SIB to have relied upon the analysis of a company which was affiliated with one of the borrowers.

- There is no record of any overall plan for the original investment which would include alternative actions which could be taken by the SIB in the event of default or changed market conditions.

- There is no documentation that the SIB considered any other course of action except for restructuring the loan when the first restructure was completed in 1989.

The Decision-making Process Which Led to the Current Restructure

- *The borrower's 1991 proposed restructure*

  In the summer of 1991, because of difficulties in leasing the space in Two Union Square at projected rental rates, the borrower proposed to the SIB that the loan be restructured again. The borrower's proposal was

that the SIB become a partner with Union Square Venture in that the SIB's loan would become a capital contribution and the SIB would share future requirements for cash contributions. Under this proposal, the SIB would share in operating income and sales proceeds with the borrower, but the SIB's returns would have been subordinate to the borrower receiving a return on its investment.

o *Review of and the development of an alternative to the borrower's proposal*

A former SIB real estate staff member and a non-voting SIB board member considered the proposal by the borrower and determined that the SIB should seek a more favorable resolution to the problem. These representatives of the SIB determined that the SIB should seek to gain control of the building, without going through foreclosure, or deed in lieu of foreclosure. The SIB representatives developed the basics of the restructure that was eventually adopted by the board, the terms of which were described in the chronology on the previous page.

Current decision-making process

After the basic form of the restructure was developed, the SIB representatives decided that there needed to be an independent review of the proposal. This was when the SIB approved hiring a business consultant to review the terms of the restructure. Lowe Enterprises was retained to conduct this analysis.

Our conclusion is that the business consultant was hired to review the terms of the restructure that had already been developed, and to ensure that the terms of the restructure protected the interests of the SIB, although there appears to be disagreement among some board members on this point. This conclusion is based on interviews with SIB board members, past and present SIB staff members, and candidates for the consulting position who were not selected. This conclusion is also based on the fact that the report prepared by the SIB's business consultant did not

Consultant review

include an economic analysis of alternatives to the proposed restructure, although other alternatives are discussed.

Observations of the Decision-Making Process

The most recent decision-making process was an improvement over previous decisions made by the board since the board retained expert legal and business advice. Overall, the restructure negotiated by the SIB is considerably more favorable to the SIB than the borrower's proposal. However, we still have some concerns with this process. Among these concerns are:

Concerns with current decision-making process

- The representatives of the SIB who formulated the restructure developed a course of action prior to retaining expert consulting advice, and without adequate quantification of alternatives. For example, there was no economic analysis comparing the value of other alternatives (foreclosure and hold the property, foreclosure and sell the property) to the recommended alternative.

- The report prepared by Lowe Enterprises did not include an economic analysis of alternatives to the proposed restructure. The audit team has requested, both verbally and in writing, that the economic analysis of alternatives be provided. No such analysis has been provided by the SIB or its legal and business consultants. Without this economic analysis, it is impossible to determine whether the restructure is the best alternative available to the SIB. The consultant contract specified that such an analysis would be conducted.[7]

- When we requested the economic analysis of alternatives, the SIB's staff, business, and legal consultants stated that such an economic analysis is not routinely conducted on loan restructures, and that it is not possible to quantify the costs and benefits of the various alternatives. We contacted numerous real

estate restructure experts around the country who indicated that economic analyses of alternatives is routinely conducted and must be conducted to adequately understand alternatives. The only people who have said otherwise are those who were involved in the SIB decision-making process.

- Foster Peper & Shefelman (FPS), the SIB's legal advisor on the restructure, has done legal work on behalf of one of the borrowers, Security Pacific Bank. Three of the FPS attorneys who advised the SIB on the loan restructure had done work on behalf of Security Pacific Bank. This creates the appearance of a conflict of interest.

- Lowe Enterprises, the SIB's business consultant, had ongoing business and financial relationships with Security Pacific Bank, which creates the appearance of a conflict of interest.[9] Other consulting firms were excluded from the competition because they had potential conflicts of interest.

Potential conflicts of interest

- The recommendation by Lowe Enterprises that a consultant should be retained by the SIB to manage the property manager, and the subsequent $250,000 per year contract to Lowe to perform this service, raises questions about Lowe's objectivity in making this recommendation.[8]

[7]Following the release of the LBC preliminary report, and six months after the audit team requested it, the SIB produced documents that could be described as an economic analysis of alternatives. This analysis was conducted by Northcoast Mortgage (historically affiliated with one of the borrowers), it does not analyze the alternative that was approved by the SIB, and assumes a worst-case scenario in the event of foreclosure.

[8]In responding to an LBC request for information about the business relationships between FPS and Security Pacific Bank, the law firm disclosed that they have performed legal services for the bank but refer to these services as "minor." Three of the attorneys who advised the SIB on the loan restructure have also done work on behalf of Security Pacific Bank.

- The retention of Lowe Enterprises to manage UNICO seems questionable given the terms of the restructure. Lowe's role as asset manager charges them with making a recommendation about whether to fire

UNICO, and thereby eliminate UNICO and Security Pacific Bank from the partnership. Lowe's ongoing business and financial relationships with the bank raises questions about their objectivity in performing this role.

Observations About the Terms of the Restructure

It may be that the restructure was the best alternative available to the SIB. There have been some reasons provided by the SIB and its consultant for why this alternative was selected rather than other alternatives. For example, restructuring the loan avoids the legal complications of foreclosure, and does not create a negative image of the building. Also, according to the SIB's consultants, UNICO has an excellent relationship with their tenants, and should therefore be retained as property manager.

Had an adequate economic analysis of alternatives been conducted, there would be greater certainty that the SIB selected the best available alternative. It seems clear that the terms of the restructure that was approved by the SIB are more favorable to the SIB than the proposal that was made by the borrower. For example, the SIB now controls the asset and receives first priority

[9]Lowe Enterprises is performing asset management services for properties owned by Security Pacific Bank. Security Pacific Bank has provided and is considering providing financing for development projects in which Lowe Enterprises has an ownership or consulting interest.

Lack of economic analyses of alternatives

on any income generated by the investment. However, it is not clear that the restructure was the best alternative available to the SIB. Also, while the restructure is not as favorable to the borrower as their original proposal, it is more favorable to the borrower in comparison with other alternatives, such as had the SIB foreclosed ~~on the property. Listed b~~elow are factors which led us to these conclusions:

Why the restructure alternative is favorable to the borrower

- Had the SIB foreclosed upon the property, the borrowers would have been required to pay taxes on the amounts that had previously been deducted for depreciation and operating losses.

- By remaining as property manager, UNICO receives property management fees, leasing commissions, and construction fees that likely will amount to several hundred thousand dollars per year.

- The SIB assumes the borrowers' responsibilities to make tenant improvements that they may have been obligated to make even had the SIB foreclosed.

- The borrowers avoid the legal costs of foreclosure.

- The borrowers can claim ongoing tax deductions from their continued interest in the property.

- As limited partners, the borrowers are not required to pay a management fee to the SIB as general partner of the partnership, as the SIB pays in each partnership in which it is a limited partner.

- The borrowers have no further liability for the ongoing operating losses of the partnership.

- If the property does become profitable, the borrowers share in an increasing percentage of the income after the SIB receives an eight percent return on its investment, to as much as 40 percent of all income after the SIB receives a 10 percent return.

Benefits of restructure to borrowers

Why it is less clear that the restructure was the best alternative available to the SIB

- The SIB assumes all of the risk of loss and the obligation for all of the future costs of the investment, but must share any profits above an 8 percent return to the SIB.

- While the SIB avoided the costs associated with foreclosure, without an economic analysis it is not possible to determine whether the short-term costs of

foreclosure outweigh the long-term costs of sharing profits with the borrowers.

o The 8 percent preferred return provided to the SIB is not equivalent to the original 10 percent interest rate of the loan. We question why the SIB should agree to share profits before receiving a return at least equal to the interest rate of the loan.

Questionable benefits of restructure to SIB

o The restructure agreement gives the SIB the authority to fire UNICO as property manager (and eliminate UNICO and Security Pacific Bank from the partnership) if financial performance targets are not met. However, there is no evidence that there has been any assessment of the legal costs of pursuing this option. Some of the real estate restructure experts that we contacted indicated that the legal process of eliminating partners from a partnership can be much more complex and costly than the foreclosure process.

o Absent other compelling evidence, it seems questionable to retain UNICO as property manager given that they have not been able to achieve profitability with the property.

o It also seems questionable to retain UNICO as property manager given a less than positive assessment of their marketing abilities (as opposed to their reputation with existing tenants) by the SIB's consultant.

o Furthermore, it seems questionable to retain UNICO as property manager since UNICO also manages properties that may compete with, and are located proximate to, Union Square.[10]

o The lease agreement between the University of Washington and UNICO to manage the UW's Metropolitan Tract properties seems unusually lucrative to the property manager.[11] The management agreement between the SIB and UNICO provides for property management fees to UNICO that are standard in the industry. This difference could provide an incentive to UNICO to locate tenants in the UW

properties at the expense of Union Square.

- o SIB board members, staff, and consultants have indicated that a major reason why they thought it was important to retain UNICO as property manager is UNICO's excellent reputation with their tenants at the Metropolitan Tract. However, given the profitable conditions of UNICO's lease with the UW, UNICO may be able to service their tenants more easily than other managers. UNICO's lease with the SIB for managing Union Square will not provide this advantage.

- o The SIB's consultant has indicated that there could be problems with servicing, and thereby losing tenants when a property manager is terminated. Currently, the vacancy rate at Two Union Square is high. If market conditions are more favorable in the future causing vacancy rates to decline, there may be more tenants to lose if the SIB chose to terminate the manager.

Questionable benefits of restructure to SIB

[10]The other major property managed by UNICO is the University of Washington's Metropolitan Tract which is located adjacent to Union Square.

[11]The lease agreement between the UW and UNICO provides UNICO with between 62 and 65 percent of the gross income from the office properties of the UW Metropolitan Tract as a property management fee. UNICO, however, is responsible for paying operating costs of the properties (but not capital costs). Industry standard property management fees provide about 3 percent of gross income to the property manager plus leasing commissions. The owner is normally responsible for both operating and capital costs.

WHAT THE SIB IS DOING TO IMPROVE THE REAL ESTATE INVESTMENT PROCESS

Development of Investment Policies and Procedures

The SIB is currently in the process of developing investment policies and procedures which could address many of the specific problems that were identified with the SIB's real estate investment process. However, since such policies and procedures have not yet been fully developed and implemented, we cannot assess whether they are adequate.

Retention of Consulting Expertise

The SIB has retained a consultant to advise them on real estate investments in general, and has also retained consultants to advise them about specific problem real estate investments. We believe that given the complexity of the SIB's real estate investments, it is prudent to retain expert consultants to provide advice about both specific investments and overall real estate policy.

However, as we have noted above, retention of consultants alone does not ensure that the decision-making process is optimal. For example, the SIB's use of consulting expertise in the Two Union Square restructure involved the provision of a reality check on a specific course of action rather than utilizing the consultant to investigate a full range of alternative courses of action. Also, the consultant that was selected had potential conflicts of interest. Additionally, we believe that consultants who recommend a course of action that results in the need for follow-up consulting services should generally be excluded from consideration for the follow-up work. See Chapter 3 for further discussion and recommendations concerning the consultant selection process.

Changes to SIB real estate investment practices

Legal Review of Real Estate Contracts

The AAG assigned to the SIB is in the process of conducting a legal review of the SIB's real estate contracts. This should improve the SIB's understanding of these contracts.

Staffing Improvements

The SIB recently hired a senior real estate staff member and is considering hiring additional real estate staff to better monitor its real estate investments. Given the complexity of the SIB's real estate investments, we agree that some additional real estate staff are needed to improve the SIB's oversight of its real estate invest-

ments.

We do not believe, however, that the provision of additional real estate staff and consulting expertise is a total solution to the problems which the SIB is trying to address by these actions. For example, in our opinion, certain SIB real estate investments are so complex that it will be very difficult to monitor them irrespective of the additional resources.

RECOMMENDATIONS

Recommendation 5

The SIB, in developing investment policies and procedures for real estate investments, should address the problems mentioned in this report. Specifically:

- ***Portfolio diversification requirements.***
- ***A process and standards for evaluating proposed investments.***
- ***A process and standards for monitoring investments, including verifying that management fees, expenses and allocations of income are in accordance with the contracts.***
- ***Standards for legal and business review of proposed investments including ensuring that contractual conflicts of interest are minimized, and those that are unavoidable are disclosed to board members, and that the contracts are not extraordinarily complex.***
- ***A process and standards for evaluating real estate managers.***

Recommendation 6

When hiring consultants to provide advice on manag-

ing specific investments, the SIB should direct the consultants to consider and analyze a full range of alternative courses of action.

Recommendation 7

When consultants are retained to analyze investments, the SIB should require candidates for the work to disclose potential conflicts of interest. If a firm which has potential conflicts of interest is considered for selection by the SIB, the SIB board members should be made aware of the potential conflicts of interest, and consider them in their selection process.

Recommendation 8

The SIB should initiate a policy in which consultants who recommend a course of action that includes a requirement for follow-up consultant work should not generally be eligible to compete for the follow-up work. There may be situations which require exceptions be made to this policy. If so, documentation of why the exception is required should be made. Consultants should be made aware of this policy prior to their retention for consulting services.

Recommendation 9

SIB board members should avoid agreeing to investments which include conflicts between the interests of the SIB and its managers. If such conflicts cannot be avoided, the board should consider whether agreeing to contracts which contain conflicts of interest is consistent with the board's fiduciary responsibility.

PUBLIC DISCLOSURE, CODE OF ETHICS, AND CONFLICTS OF INTERESTS

Chapter Six

Standards and requirements for ethical conduct by state officers and employees are governed by: Chapter 42.18 RCW (Executive Branch Conflict of Interest Act); Chapter 42.20 RCW (Misconduct of Public Officers); Chapter 42.21 RCW (Code of Ethics for Public Officers and Employees); and EO 80-16 (Executive Order Concerning Conflict of Interest). Under the public disclosure law, Chapter 42.17 RCW, only board members and the executive director are required to file annual financial affairs statements with the Public Disclosure Commission. However, the Executive Branch Conflicts of Interest Act gives agency heads responsibility for protecting against actual or potential conflicts of interest on the part of staff. Such protection may include filing of financial affairs statements.

Background

PREVIOUSLY DISCLOSED ISSUES

Both the press and the consulting firm of Deloitte & Touche have pointed out the board's absence of a code of ethics specific to the SIB and the lack of a formal, adopted policy for full financial disclosure by all board members and staff. They have also noted that in the past, nobody at the SIB reviewed the disclosure forms that were submitted by members and staff.

An environment where conflicts of interest can occur

The lack of an agency-specific code, and policies and procedures that would ensure that a code is followed, create an environment in which potential conflicts of interest can occur. Some of the specific situations that exist, which create such an environment, are:

- The absence of a process to assure against:

- Board members or key staff steering business to friends or business associates.

- Board members or staff having investments in companies that are owned by, do business with, or otherwise receive money from the SIB.

- Board members or staff using insider information for their personal gain.

o Campaign contributions to publicly elected officials who serve on the board from individuals or entities that do business with the board.

o Elected officials voting on matters that would benefit campaign contributors.

o Firms doing business with the SIB can pay for members' and staff's travel and accommodations.

LBC STUDY OBJECTIVES

As mentioned in Chapter 3, allegations concerning former SIB employees using insider information and/or failing to adhere to statutory requirements to avoid potential conflicts of interest are being investigated by the SIB's AAG. Since this investigation is still in progress, we are not addressing these specific allegations in this report.

Our objective for this part of our audit was to understand how conflicts of interest might exist on the board, and to assess how the board is attempting to mitigate or eliminate the potential for such conflicts.

FINDINGS

Our review of the SIB has confirmed that the situations mentioned above, which can create the potential for conflicts of interests, have existed. Currently the board is in the process of developing a code of conduct that is meant to avoid many of these situations in the future. A list of the topics that are being considered for inclusion in this code are included in this report as Appendix 4. Because this code of conduct is not scheduled to be completed until August 1992, we cannot comment on it at this time. The topics we will focus on here are: the actions currently being taken by the board; and areas that will not be covered by the proposed code and that still need attention and consideration by the board and the legislature.

SIB is developing a code of conduct

Actions Being Taken by the SIB

All board members and staff have now filed public disclosure statements. These statements are reviewed by the assistant attorney general who represents the board. The board is currently in the process of creating a data base of investments that can be cross-checked with the information on the disclosure forms.

As was reported in the press, a staff member who had stock in an affiliate of a company in which the SIB invests, and who had made recommendations on that investment, recently resigned from the SIB.

Potential Conflicts of Interest

Chapter 42.18 RCW (Conflict of Interest Act) and Chapter 42.22 RCW (Code of Ethics) are designed to prohibit public officers and employees from having conflicts of interest. Additionally, as fiduciaries, SIB voting members must exclude not only their own interests but also the interests of third parties when they carry out their duties. Thus conflicts of interest, such as favoritism to friends and associates, would constitute a breach of duty.

Although the board is developing a code of conduct that is meant to prohibit and ensure against unethical behavior on the part of

members and staff, some of the situations that create an environment for conflicts to occur can also be avoided. This can be accomplished by having a better process for hiring managers and consultants, and for entering into partnership agreements.

Elsewhere in this report we have identified some specific problems that need to be addressed. For example:

- Some SIB contracts that are neither sole source nor emergencies have been awarded without following the statutorily required competitive process.

- Some contracts that should have been competitively bid were nevertheless filed as sole source or emergencies.

- There exists no documented process by which some managers were hired and some agreements were entered into.

- In some cases, significant decisions have been made and courses of action taken without obtaining expert advice beforehand and without full consideration of alternatives.

- In at least one case an advisor's potential conflict of interest was not made known to the voting board members.

- Some major contracts were entered into as subcontracts and therefore avoided the statutorily required competitive process. Moreover, the general contractor had not been hired competitively to provide the range of services it was providing.

The SIB has committed to create a process that will address most of the foregoing problems. In Chapter 2, we have included a recommendation that will address a remaining problem: specifically, the need to competitively bid and file each subcontract, and for OFM to review sole-source or emergency exemptions concerning subcon-

tracts on a case-by-case basis. This recommendation is particularly important since it would ameliorate a situation in which the potential for abuse is great because of the current lack of oversight and accountability. We believe that the SIB's follow-through on its commitment, and the legislature's action on Recommendation 4 in Chapter 4 of this report, would help to create an environment less conducive to potential conflicts of interest, favoritism and other forms of abuse of position.

Campaign Contributions

The SIB includes among its members three publicly elected state officials: the State Treasurer, and one member each from the Senate and the House of Representatives.

The code of conduct being developed by the SIB will not specifically address potential conflicts of interest that can occur if publicly elected board members make decisions that would benefit campaign contributors, or receive campaign contributions from persons or entities who do business with the board. The board may decide to take up the issue of campaign contributions at a later date, but it is not clear at this time whether the board would have authority in this area.[1]

Issue of campaign contributions needs to be addressed

The creation of an open, competitive process for doing business will help to reduce but will not eliminate the potential for conflicts of interest that might result from accepting campaign contributions. In an effort to reduce both the potential and the appearance of conflicts of interest, the incumbent State Treasurer (who is the current board chair) has developed voluntary guidelines for himself with regard to campaign contributions. These guidelines include:

[1]The information that the proposed code will not address campaign contributions, and that the board might not have the authority to address the issue in any case, was provided to us by the assistant attorney general who is representing the SIB and who is preparing the draft code of conduct.

- Not accepting any personal or campaign contributions

State Treasurer's guidelines

from any person, corporation, or partnership under contract with the State Investment Board as a general partner or money manager. This prohibition will extend to executive officers of a corporation, the corporation, or partnerships as well as any individual acting on behalf of any general partner or money manager.

- Contributions from other corporations, partnerships or individuals who may do business with the State Treasurer's Office or State Investment Board will be accepted only if the business is granted through a formal bid process.

- If any institution or person whose contribution has been accepted subsequently applies to become a general partner or money manager, the State Treasurer will exclude himself from the decision-making process.

As we have discussed with the State Treasurer, while these guidelines help to reduce the appearance and the potential for conflicts, they do not cover all contingencies. Moreover, these guidelines are voluntary only and do not obligate future State Treasurers or other elected officials who are SIB members.

Joint Board of Ethics has power to set rules

Although it is unclear whether the SIB has authority to address matters of campaign contributions, this authority is vested in the State Legislature. The legislature could set any parameters for board members accepting campaign contributions, and concurrently the SIB could set parameters, based on their fiduciary responsibilities, for when members should exclude themselves from voting. Under RCW 44.60.070, the Joint Board of Ethics of the legislature has the power and duty of advising and of proposing rules and recommending legislation relating to legislative ethics. Presumably, any rules of ethics for legislators on the SIB that the Joint Board might recommend would reasonably apply to the State Treasurer as well.

RECOMMENDATIONS

Recommendation 10

The LBC should request the Joint Board of Ethics to advise the legislature as to any parameters that should be set concerning the acceptance of campaign contributions by legislators who serve on the SIB.

Recommendation 11

The State Investment Board should address the issue of the circumstances under which members should exclude themselves from voting. One of the circumstances specifically considered should be the acceptance of campaign contributions.

OVERSIGHT OF THE STATE INVESTMENT BOARD

Chapter Seven

Background

By statute (RCW 43.334.150), the SIB is required to prepare and submit quarterly reports to the Governor, the Senate Ways and Means Committee, the House Appropriations Committee, and the Department of Retirement Systems. The SIB must also report to the Senate Financial Institutions and Insurance Committee and the House Commerce and Labor Committee at least annually on the board's investments of Department of Labor and Industries funds. Other than these specific reporting requirements, and the appropriation process, statute does not provide for any ongoing legislative oversight of the SIB's overall operations and performance.

Post audits of financial transactions of state agencies, including the SIB, fall under the authority of the State Auditor (Chapter 43.09 RCW). Although the State Auditor is specifically prohibited from conducting performance audits, statute does empower the Auditor to take exception to specific expenditures that have been incurred by any agency, or to take exception to other practices related in any way to an agency's financial transactions (RCW 43.88.160). Under this authority the State Auditor can conduct compliance reviews.

The authority and responsibility for conducting performance audits is vested in the Legislative Budget Committee (RCW 43.88.160 and RCW 43.28).

PREVIOUSLY DISCLOSED ISSUES

Individual board members have had concerns with the operations and with some investments of the SIB in the past. The majority of the board felt strongly enough about these concerns toward the end of 1990 that they initiated analyses of individual investments and began the process that resulted in the subsequent reports by Deloitte & Touche and the law firm of Foster Pepper and Shefelman. Meanwhile, investigative reporting by the *PI* resulted in additional disclosures about the SIB's oversight of expenses, and questions about conflicts in employees' investment practices.

These issues and concerns have been expanded upon in previous chapters of this report.

Little outside overview of SIB

Recent publicity about the variety and severity of problems being faced by the board led many people to question why the problems were not brought to light earlier. An underlying reason suggested in the press, which we have also heard in our own interviews, is that little attention was paid to the detailed operations of the board (by everyone in government, including the board itself) as long as investment returns were thought to be superior.

Questions have been raised, too, about who should have been auditing the SIB, and how should auditing and oversight of this agency take place in the future.

LBC STUDY OBJECTIVES

Is ongoing oversight warranted?

Our objective was to evaluate whether ongoing legislative oversight of the SIB, its operations, and its investment performance is warranted, and if so, the form or forms such oversight might take.

ISSUES FOR CONSIDERATION BY THE LEGISLATURE

In prior chapters we have discussed in detail problems associated with the SIB's operations and decision-making process. We have

also noted how the board and its staff are tackling these problems, and we have made recommendations on further improvements in these areas. Our recommendations do not, in the main, address external accountability of the SIB. This has been limited in the past, and in our opinion has contributed to an environment where:

Issues related to lack of oversight

- The SIB's decision-making processes, investment practices, and performance were not questioned.
- Contract compliance was not thoroughly monitored or independently verified.
- The legal and economic ramifications of investment options and decisions were not adequately evaluated.
- There was the potential for conflicts of interest in the SIB's decision-making processes.

More extensive third-party knowledge and review of the SIB's activities might have raised enough questions at an early enough stage that some of the problems explained in this report, and their impact on the pension funds, could have been avoided.

Some problems could have been avoided

Where do we go from here? The answer to this question is likely to have several components because neither the legislature nor any of the agencies mentioned above is well situated to provide for all of the auditing and oversight needs alone. From our knowledge of the current legislative committee structure and the authority and responsibilities of the various agencies involved, and our understanding of the SIB gained through this study, we suggest the following approach to providing oversight.

Investment and Manager Performance

Suggested approach to oversight

Review of investment returns and managers' performance is a basic responsibility of the board. This review of performance requires special expertise, however, and is best done continually, and preferably not in-house so that the people making investment decisions are not reviewing their own performance.

The SIB is currently addressing these needs. It has hired a pension advisor to review past and present performance and to assess managers. In addition, the SIB has hired real estate and alternative investment consultants to review performance in these areas. The calculation of returns will also now be done outside the agency by the SIB's custodian bank.

Partnership Expenses and Contract Compliance

This audit report has shown that the expenses, allocations and distributions of partnerships need to be monitored. With a few exceptions the SIB has the authority to review the financial records of its partnerships and other contractual relationships. The State Auditor also has the authority to perform compliance reviews. These audits can be designed to determine if the financial terms of agreements have been kept.

The SIB is planning to hire a senior investment officer who, among other duties, will monitor management fees. Recommendation 2 of this report would expand this function to include a review of past and current expenses and allocations and distributions. In order to carry out this workload, the investment officer may need the assistance of the alternative investment consultant and the assistant attorney general (for interpretation of agreements).

The State Auditor could also provide assistance as part of its financial auditing function.

Public Disclosure and Conflicts of Interest

The SIB has the responsibility to ensure that conflicts of interest do not occur. The board is now attempting to fulfill this responsibility by: developing a code of conduct; requiring that all members and staff submit disclosure statements; and review of the statements by the Assistant Attorney General who represents the board.

Recommendations 10 and 11 of this report concern campaign contributions to board members who are publicly-elected officials. The results of action taken on these recommendations potentially could be incorporated into the board's code of conduct.

Personal Services Contracts

The Office of Financial Management has the responsibility for reviewing agency requests for emergency, sole source, and expert witness contracts, and amendments to contracts when they exceed fifty percent of the value of the original contract. The SIB has responsibility for ensuring that contracts not submitted to OFM for review (i.e., those categories mentioned above) follow competitive procurement requirements.

As discussed in Chapter 4 of this report, the SIB has informed us that it is taking steps that will help it to better fulfill its responsibilities in procuring personal services contracts. Chapter 4 also includes a recommendation that is aimed at avoiding abuses that can occur by hiring consultants as subcontractors.

Policy Oversight

Examples of policy issues that are in the purview of the legislature rather than the SIB include:

- The composition of the State Investment Board

  The legislature has considered expanding the membership of the SIB by adding the State Actuary and more legislative members.

- Role of Non-voting Board Members

  Also, now that the SIB is hiring additional staff and has engaged consulting firms who are expected to provide expert advice, the traditional, extensive reliance on non-voting board members for expert advice is changing. A question the legislature might consider is the appropriate role or need for board members who are not trustees and who are non-voting.

- Board Investment Policy

Under state statute the SIB has broad investment discretion. How the board interprets that discretion and limits it through its strategic allocation and investment policy decisions are potentially matters of interest to the legislature.

This increased oversight role could be provided by the Joint Committee on Pension Policy (JCPP) in conjunction with the appropriate standing committees.

Before we began this performance audit, the JCPP was interested in what its role should be vis-a-vis the SIB. Our understanding is that the committee is planning to consider this matter after the issuance of this report.

Operational Audits

There are both near-term and long-term concerns that would argue for additional and ongoing performance audits of SIB operations. In the near-term there are a number of questions about SIB operations that have not been completely resolved in this report, and there are major areas of the board's operations we did not review. There is also the matter of how to evaluate some of the corrective actions the board has taken. To take just one example, a major, new direction the board has taken is to hire a number of consulting firms as advisors. How will the SIB evaluate its advisors and how will it eventually decide on the best mix of employees and outside expertise? The next cycle for renewing the consulting contracts, if this is what the SIB decides to do, would be early 1995.

Uniqueness and importance of the SIB warrants ongoing oversight

In the long-term, the magnitude and importance of the SIB, with its assets totaling $22 billion and its separation from usual Executive branch oversight, could be considered sufficient reason for the legislature to provide for ongoing operational review. Since the SIB has shown itself to be a changing organization, a set schedule for review by the LBC might not be the most effective option. A practical alternative would be for each LBC audit to recommend the time frame for the next audit. This option would take advantage of the knowledge gained about the SIB, and issues related to it, at the time.

RECOMMENDATIONS

Recommendation 12

The State Investment Board should prepare a report to the LBC by March 1, 1993, that will indicate the actions taken by the board in response to the formal findings and recommendations of this report, and in response to the other matters referenced herein.

Recommendation 13

The Legislative Budget Committee should perform a follow-up performance audit of the SIB during the 1993-1994 fiscal year.

SCOPE AND OBJECTIVES

Appendix 1

SCOPE

This audit will examine the operations, responsibilities and composition of the State Investment Board (SIB) and its staff organization, and will review the role of the SIB within the larger state investment policy system.

OBJECTIVES

1. Evaluate whether the general issues and the specific concerns recently raised in the press, in Board-commissioned consultant studies, by members of the Board, and by members of the Legislature represent problems that need to be addressed by the Board and/or the Legislature.

2. To the extent that problems are or have been confirmed, determine whether the SIB has established and/or is creating and implementing policies and procedures that will adequately address them.

3. Evaluate the state investment policy system, focusing on the role of the SIB, the checks and balances within the system, and how the system ensures the fiscal integrity/liability of state investment funds.

4. Based on the results of the study efforts related to Objectives 1, 2 and 3, evaluate whether ongoing legislative oversight of the SIB, its operations, and its investment performance is warranted, and if so, the form or forms such oversight might take.

AGENCY RESPONSE

Appendix 2

- State Investment Board

MEMBERSHIP OF THE STATE INVESTMENT BOARD

Appendix 3

EX-OFFICIO MEMBERS

- State Treasurer
- Director, Department of Labor and Industries
- Director, Department of Retirement Systems

LEGISLATIVE MEMBERS

- Member of the House of Representatives appointed by the Speaker of the House
- Member of the Senate appointed by the President of the Senate

GOVERNOR APPOINTEES

- One active member of the Public Employees Retirement System
- One active member of the Law Enforcement Officers' and Fire Fighters' Retirement System
- One retired member of a state retirement system

SUPERINTENDENT OF PUBLIC INSTRUCTION APPOINTEE

- One active member of the Teachers' Retirement System

NON-VOTING MEMBERS

- Five non-voting members appointed by the voting members

PCIG INVESTMENT STRUCTURE

Appendix 4

SIB CODE OF CONDUCT
(TOPICS CURRENTLY UNDER REVIEW)

Appendix 5

The SIB's audit committee, with technical assistance from the legal counsel in the Attorney General's office, is developing a code of conduct. The board is scheduled to review a draft of a proposed code in August 1992.

The topics that the audit committee are currently considering to be addressed in the code include:

1. Gifts

2. Travel

    a. Speaking engagements

    b. Partnership meetings

    c. Conferences, training

    d. Other

3. Investments - purchase and sale

4. Conflicts of interest and disclosure thereof

5. Use of position, assisting in transactions

6. Outside employment and compensation

7. Dealing with the press and other outside groups